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Supreme Court, U.S.
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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

ESTATE OF LOUIS YAEGER, DECEASED, JUDITH WINTERS, RAPHAEL MEISELS, ABRAHAM K. WEBER, AND THE BANK OF NEW YORK, EXECUTORS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

RICHARD A. LEVINE
ROBERTS & HOLLAND
Counsel of Record
30 Rockefeller Plaza
New York, New York 10112
(212) 903-8700

CARLTON M. SMITH
ROBERTS & HOLLAND
Counsel for Petitioner
30 Rockefeller Plaza
New York, New York 10112
(212) 903-8700

Of Counsel:
SIDNEY I. ROBERTS
ROBERTS & HOLLAND
30 Rockefeller Plaza
New York, New York 10112
(212) 903-8700

January 31, 1990

QUESTIONS PRESENTED

1. Is an individual who derives his livelihood solely from active, full-time speculative buying and selling of securities for his own account on a daily basis engaged in a trade or business for Federal income tax purposes?

2. Does the Internal Revenue Code grant jurisdiction to the United States Tax Court to determine a deficiency in income tax with respect to a tax year which is nowhere mentioned in either the notice of deficiency issued by the Commissioner of Internal Revenue, the petition filed with the Tax Court by the taxpayer, or the answer to the petition filed by the Commissioner?

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Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The petitioner, the Estate of Louis Yaeger (hereinafter, the "Estate"), respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Second Circuit, entered in the above-entitled proceeding on November 7, 1989.

OPINIONS BELOW

The opinion of the Court of Appeals (App., *infra*, 1a-15a) is reported at 889 F.2d 29. The opinion of the United States Tax Court with respect to the first question presented (App., *infra*, 16a-31a) is numbered T.C. Memo. 1988-264 and is unofficially reported at 55 T.C.M. 1101 and ¶88,264 PH Memo TC. The order of the United States Tax Court with respect to the second question presented (App., *infra*, 32a-34a) is unreported.

JURISDICTION

The judgment of the Court of Appeals was entered on November 7, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

STATUTES INVOLVED

The relevant portions of Internal Revenue Code sections 163, 6201(a), 6203, 6212, 6213(a), 6214, 6303(a), 6501(a), 6503(a), and 6512(b),[1] as in effect for the tax years 1979, 1980, and 1981, are set out in a statutory appendix. (App., *infra*, 35a-39a.)

STATEMENT OF THE CASE

A. *First Question Presented — Trade or Business Issue.*

1. For more than 40 years, including the years in issue, 1979 and 1980, Louis Yaeger (hereinafter, "Yaeger") earned his livelihood through active, full-time speculative buying and selling of securities on a daily basis. Yaeger graduated Phi Beta Kappa from Columbia College in 1921, having studied business and finance. Commencing in the mid-1920's, Yaeger began actively trading stocks and bonds on the stock market for his own account in addition to conducting an investment counseling business. In the 1940's, he gave up his investment counseling business because the management of his own account had grown so demanding. Thereafter, he devoted himself exclusively to trading securities for his own account, which was his sole occupation and source of livelihood until the day he died in 1981. (App., *infra*, 18a.)

Prior to 1979, Yaeger maintained accounts with several brokerage firms in New York. His account at H. Hentz & Co.

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[1] Unless otherwise noted, all section references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended and as in effect for the tax years 1979, 1980, and 1981 (the "Code").

was the largest account that firm had maintained for an individual United States citizen. (App., *infra*, 18a-19a.)

During 1979 and 1980, Yaeger maintained an office at H. Hentz & Co. from which he conducted most of his trading activity. H. Hentz & Co. also provided Yaeger with an assistant, a telephone, use of the secretarial pool, and access to its research staff and facilities. Yaeger's assistant answered the telephone, placed his purchase and sale orders and assisted his research efforts. (App., *infra*, 19a.)

Yaeger worked every day of the week. He spent a full day at his office, researching securities opportunities and placing purchase and sale orders. After he returned home from the office, he read financial reports late into the night. When he was out of town, he maintained telephone contact with the brokers who handled his accounts. Yaeger was trading on the stock market the day before he died. His tremendous industry stemmed from his profound enjoyment of the subject matter he studied. (App., *infra*, 19a-20a.)

During the years in issue, 1979 and 1980, Yaeger owned stock in more than 500 different companies which were traded on the New York Stock Exchange ("NYSE"), the American Stock Exchange ("AMEX") and the Over-the-Counter Market ("OTC"). He made purchases or sales nearly every day the securities markets were open and in more than 200 companies each year. Yaeger's extensive trading activity during the years 1979 and 1980 is summarized in the following schedule (Exs. 25-27, 30-32)[2]:

Year	Number of Purchase Transactions	Number of Sales Transactions	Number of Shares Bought	Number of Shares Sold
1979	1,176	86	1,453,555	822,955
1980	1,088	39	1,658,841	173,165

[2] References herein to "Ex." are to exhibits in the record of this case. References to "Stip." are to paragraphs of the stipulation of facts entered into in this case.

The total cost to Yaeger of the stocks traded on the NYSE, AMEX, and OTC and of bonds which he owned on December 31, 1979 and December 31, 1980, was as follows (Exs. 25-27):

	12/31/79	12/31/80
NYSE Stocks	$43,966,557	$56,129,220
AMEX Stocks	11,839,993	13,159,639
OTC Stocks	4,205,181	6,243,250
Bonds	1,036,764	1,204,704
Total Cost	$61,048,495	$76,736,813

Yaeger subscribed to a distinct strategy in his stock market activities. His strategy was to buy the stock of companies whose stock prices were extremely depressed. He rarely purchases "blue chip" stocks, and many of the stocks he held did not pay dividends. Instead, Yaeger constantly looked for companies which were experiencing financial distress and whose underlying value was not widely recognized. (App., *infra*, 20a.)

Yaeger's strategy required extensive and thorough research. Yaeger searched the listing of stocks whose prices had recently hit new low levels, ceased paying dividends, or gone into bankruptcy, particularly companies which held valuable but underutilized assets. (App. *infra*, 20a.)

In addition to the risk involved in selecting financially troubled companies in which to speculate, Yaeger substantially increased his risk by using margin debt. He financed his activities by borrowing to the maximum extent allowable under law and the custom of the brokerage houses, which was generally 50 percent of the closing price of the securities. If the value of his stock rose, he would use that increased value as equity to support more debt. From time to time, Yaeger shifted accounts from one brokerage house to another in order to maximize the amount of margin debt he could carry. (App., *infra*, 22a.)

During the years 1979 and 1980, the ratio of Yaeger's margin debt to portfolio value was 47 percent and 42 percent, respectively. Yaeger's total stock market related debt was $42,154,048

at the end of 1979 and $54,968,371 at the end of 1980. When he died in May 1981, his portfolio was subject to debt in the amount of $70,490,018. (App., *infra*, 22a.)

Yaeger's maximum use of margin debt occasionally created problems for him because if the value of his holdings in a particular account fell below the amount which the brokerage firm required to support the debt that the account was carrying, he was forced to sell enough stock to cover the debt, even if the sale resulted in a loss. Once or twice during the course of his career, Yaeger was almost "wiped out." (App., *infra*, 22a.)

A further indication of the speculative nature of Yaeger's portfolio is reflected in the following table, which shows the ratio of interest and dividend income he received during 1979 and 1980 to the closing price value of his securities on the last days of those years (*i.e.*, its yield) compared to the yields on six-month U.S. Treasury Bills during those years:

		Yield on 6-month T-Bills	
Year	Yield on Portfolio	High	Low
1979	3.12%	12.12%	8.94%
1980	2.82	14.60	7.85

(Stip. para. 11; Exs. 28, 29.) Of the more than 500 different issues Yaeger owned on December 31, 1979 and December 31, 1980, 133 issues and 131 issues, respectively, paid no interest or dividends at all. (Exs. 25-27.)

Yaeger dedicated as much thought and careful planning to the decision of when to sell stock as he did to the decision of what stock to buy. He tried to hold stocks until they had increased in price to a level which reflected what he considered to be the company's true worth. Because he waited until there was a high enough price and corresponding demand in the market by purchasers, he was usually able to sell his stock quickly. (App., *infra*, 22a-23a.)

Of the stock which Yaeger sold in 1979 and 1980, the percentage of total sales of securities which he had held for 12 months or more was 88 percent and 91 percent, respectively. (App., *infra*, 23a.)

Yaeger incurred substantial interest expense on his margin debt. On Schedule C of the joint Federal income tax returns which he filed, Yaeger deducted interest expenses in 1979 and 1980 in the amounts of $5,865,833 and $7,995,010, respectively. (App., *infra*, 24a.) Those amounts greatly exceeded the dividend and interest income he received in each of those years ($2,397,038 in 1979 and $3,740,158 in 1980).

In 1979 and 1980, Yaeger reported income in the following amounts on his Federal income tax returns (App., *infra*, 23a):

Year	Character of Income	Amount
1979	Net Long-Term Capital Gain ...	$ 13,839,658
	Net Short-Term Capital Gain ...	184,354
	Dividends	2,339,080
	Interest Income.....	57,958
	TOTAL	$ 16,421,050
1980	Net Long-Term Capital Gain ...	$ 1,099,921
	Net Short-Term Capital Gain ...	728,404
	Dividends	3,648,441
	Interest Income.....	91,717
	Director's Fees.....	10,600
	TOTAL	$ 5,579,083

2. Interest expense incurred in a trade or business is allowed in full and is not considered investment interest subject to the limitations of section 163(d).[3] On audit, the Commissioner of Internal Revenue (hereinafter, the "Commissioner") determined that Yaeger was not engaged in a trade or business with respect to

[3] H.R. Rep. No. 413, 91st Cong., 1st Sess., pt 1, at 73 (1969).

his securities transactions in 1979 and 1980 and that the interest expenses he incurred and deducted on Schedule C should be treated as investment interest, subject to the limitations on the deduction of such interest provided in section 163(d). As a result, the Commissioner issued a notice of deficiency to the Estate in which he did not allow as a deduction $3,567,252 of Yaeger's interest expense for 1979 and $3,641,156 of Yaeger's interest expense for 1980. Imposing the section 163(d) limitation on the deduction of interest expense produced income tax deficiencies of $650,833 and $513,188 for 1979 and 1980, respectively, as reflected in the decision entered against the Estate in the Tax Court.

3. The Estate contested the notice of deficiency in the Tax Court on the ground that Yaeger was engaged in a trade or business and, therefore, the interest expense he incurred should be allowed in full. That court found that Yaeger had satisfied all of the requirements of being engaged in a trade or business as set forth by this Court in *Commissioner v. Groetzinger*, 480 U.S. 23 (1987) (*i.e.*, devoting full time to the activity, active involvement, sole source of livelihood). However, the Tax Court imposed an additional requirement, holding that to be engaged in a trade or business involving securities (other than as a dealer), an individual must seek his profit "primarily from frequent exchanges which take advantage of short-term swings in the market rather than from interest, dividends and long-term appreciation." (App., *infra*, 27a.) Only because the Tax Court found that Yaeger had "held his stocks and bonds a lengthy period hoping for capital appreciation" (*id.*, at 30a), it held that Yaeger was not engaged in a trade or business.

The Estate appealed the Tax Court's ruling to the Second Circuit on an issue of law, arguing that the requirement imposed by the Tax Court to establish the existence of a trade or business — *i.e.*, that a taxpayer must derive profit from "short-term swings" in the price of the stocks — was in conflict with several appellate and trial court opinions and was not consistent with this Court's opinion in *Commissioner v. Groetzinger*, *supra*. The Second Circuit affirmed. It stated that "[i]nvestors derive profit from the interest, dividends, and capital appreciation of securities" (App., *infra*, 7a) and that they are primarily interested in the

long-term growth potential of their stocks. (*Id.*) The Second Circuit contrasted investors with "traders" who, the court said, "endeavor to catch the swings in the daily market movements and profit thereby on a short term basis." (*Id.* at 7a-8a.) The circuit court erroneously focused on whether Yaeger was a "trader", a term which is not used in the statute, and not whether Yaeger was engaged in a "trade or business" (the statutory term), and said "the two fundamental criteria that distinguish traders from investors is (sic) the length of the holding period and the source of the profit." (*Id.* at 8a.) Since Yaeger's activities emphasized long-term capital appreciation, he was held by the court to be an investor, not a trader, and therefore not engaged in a trade or business.

The court improperly cited legislative history of section 163(d) as supporting its decision to deny an interest deduction to Yaeger, incorrectly stating: "The activity of holding securities for a length of time to produce interest, dividends, and capital gains fits the abuse targeted by section 163(d): investing for postponed income and current interest deduction." (App., *infra*, 8a-9a.) However, no such "abuse" is present in this case since the taxpayer had claimed an interest deduction to offset only the income from the activity to which the interest expense related.

B. *Second Question Presented — Tax Court's Jurisdiction.*

1. Yaeger died on May 11, 1981. (App., *infra*, 10a.) As a result, Yaeger's taxable year ended on May 11, 1981 and the Estate was required to file a short-period income tax return for the period January 1, 1981 to May 11, 1981. Sections 441(b)(3) and 443(a)(2); Treas. Reg. §1.443-1(a)(2). The Estate filed that income tax return, which clearly reflected the correct taxable year, January 1, 1981 to May 11, 1981, on which it reported Schedule C interest deductions in the amount of $489,373. (*Id.* at 14a.)

As a new taxpayer, the Estate elected April 30 as its fiscal year end. The Estate filed an income tax return for the period May 11, 1981 through April 30, 1982. (App., *infra*, 33a.) On the return for the year ended April 30, 1982, the Estate reported Schedule C

interest deductions in the amount of $3,909,942. The Commissioner did not object to the Estate's adoption of an April 30 fiscal year. (*Id.* at 33a.)

2. On April 15, 1983, the Commissioner issued a notice of deficiency to the Estate. The upper right-hand corner of the notice of deficiency sets forth the following: "Tax Year Ended and Deficiency: 12/31/81 $451,660.25 Delinquency Addition $67,749.00." On all other pages attached to the notice, the taxable year was also shown as ending "12/31/81" or "December 31, 1981." (App., *infra*, 10a, 33a.) In all, the tax year ended December 31, 1981 is referred to twice in the notice of deficiency itself and ten times in the attachments to the notice of deficiency, and there is not a single reference anywhere to May 11, 1981 or to the taxable year January 1, 1981 to May 11, 1981.

In the attachments to the notice of deficiency, the Commissioner proposed adjustments to the interest expenses claimed by the Estate. The investment interest limitation was computed by the Commissioner on a Form 4952 attached to the notice. In Part II, line 5, of the form, interest expenses on investment debts for the year (exclusive of carry-overs) were shown as $3,907,422 — an amount nearly equal to the amount of interest expenses reported by the Estate on the income tax return it filed for the period ended April 30, 1982. On the other hand, other items on the attachments appeared to be derived from the income tax return which the Estate filed for the taxable year ended May 11, 1981. (App., *infra*, 13a-14a.)

3. On July 13, 1983, the Estate filed a petition with the United States Tax Court which was prepared by Howard J. Misthal, the Estate's accountant who is admitted to practice in the Tax Court. The petition, in paragraph 3, contested both the notice of deficiency issued to the Estate by the Commissioner for the tax year ended "12/31/81" and the separate notice of deficiency issued by the Commissioner for the years 1979 and 1980. In paragraph 3 of the Estate's Tax Court petition, the deficiencies, as determined by the Commissioner, were alleged to be "in income taxes for the *calendar years* 1979, 1980 and 1981." (Emphasis added.) In its prayer for relief, the Estate prayed that the Tax Court determine that there were no deficiencies due from the petitioner for "the *calendar years* 1979, 1980 and 1981." (Emphasis added.)

In the answer he filed with the Tax Court, the Commissioner admitted the allegations contained in paragraph 3 of the petition – that the years in issue were the *calendar years* 1979, 1980, and 1981.

Approximately two years after the petition was filed by the Estate with the Tax Court and after the case was calendared for trial, the Estate retained Richard A. Levine, Esq., who entered his appearance as counsel in the case. The Estate's former counsel of record, Howard Misthal, withdrew his appearance shortly thereafter. In October 1985, while preparing the case for trial, Mr. Levine first noted that the Estate had filed no return for the period covered by the notice of deficiency for the year ended December 31, 1981. Mr. Levine promptly brought this fact to the attention of the Tax Court by filing a motion to dismiss the year ended December 31, 1981 from the case for lack of jurisdiction. That motion noted that the Estate had a taxable year ended May 11, 1981 and a taxable year ended April 30, 1982 and that neither of those taxable years was set forth in the notice of deficiency, which referred to a December 31, 1981 year.

The Commissioner opposed the Estate's motion and asked the Tax Court to read the notice of deficiency he issued to the Estate for the year ended "12/31/81" as determining a deficiency with respect to Yaeger's taxable year beginning January 1, 1981 and ending May 11, 1981.

The Tax Court granted the Estate's motion to dismiss the 1981 year, holding that the notice of deficiency, which on its face appeared to cover portions of two distinct taxable years for which the Estate had filed returns and which provided no indication that only one correct taxable year was the subject of the notice, was invalid. (App., *infra*, 32a-34a.)

The Commissioner appealed the Tax Court's dismissal to the Second Circuit. The Second Circuit reversed the Tax Court. The Second Circuit did not address the fact that the Tax Court's jurisdiction is fixed by the Internal Revenue Code and that section 6214 provides that the Tax Court only has jurisdiction over the tax year set forth in the notice of deficiency for which a Tax

Court petition is timely filed and that it does not have jurisdiction as to any other tax year. Instead, the circuit court noted that the statute does not specify the form or content of a valid notice of deficiency. It held that a notice of deficiency must meet the general fairness requirements of due process and that mistakes in the content of the notice which do not frustrate its purpose are to be disregarded. (App., *infra*, 11a.) The court stated: "The test for determining whether the notice's purpose was accomplished is whether the taxpayer reasonably knew or should have known that the deficiency notice was directed to the taxpayer, that a deficiency determination was made, the taxable year involved, and the amount of the deficiency." (*Id.* at 11a-12a.) The court held that the Estate should have understood that the Commissioner intended the notice of deficiency to relate to Yaeger's taxable year ending May 11, 1981. Accordingly, it held that the notice of deficiency and the petition filed by the Estate vested the Tax Court with jurisdiction over the tax year which the Commissioner intended to be covered by the notice of deficiency. (*Id.* at 13a-14a.)

REASONS FOR GRANTING THE WRIT

A. *First Question Presented — Trade or Business Issue.*

The decision below is squarely at odds with this Court's decision in *Commissioner v. Groetzinger*, 480 U.S. 23 (1987), and it conflicts with decisions of the Fourth Circuit Court of Appeals in *Commissioner v. Nubar*, 185 F.2d 584 (4th Cir. 1950), cert. denied, 341 U.S. 925 (1951) and *Adda v. Commissioner*, 10 T.C. 273 (1948), aff'd per curiam, 171 F.2d 457 (4th Cir. 1948), cert. denied, 336 U.S. 952 (1949). The decision below also produces an irrational result not intended by Congress: it taxes the taxpayer's gross long-term gains from his activities and never allows him to deduct the interest cost he incurred in order to realize those gains.

In 1987, this Court attempted to clarify the meaning of the term "trade or business" for tax purposes by enunciating, in *Commissioner v. Groetzinger*, *supra*, the principles to be applied in determining when a taxpayer is engaged in a trade or business. In *Groetzinger*, the issue was whether a full-time gambler was

engaged in a trade or business. The Court stated "that to be engaged in a trade or business the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit." 480 U.S. at 35. In the instant case, the Second Circuit has added two further requirements applicable only in the securities area — that a taxpayer can be engaged in a trade or business only if (a) he seeks to catch swings in the daily market movements and profit thereby on a short-term basis, and (b) he does not earn his profits in the form of capital gains arising from long-term capital growth. As will be shown, these additional requirements for being in a trade or business are illogical and arbitrary. Further, in the context of section 163(d), these requirements lead the court to a result which is directly opposite to the result intended by Congress, which was to allow interest incurred in a trade or business to be deducted in full when paid or incurred.

1. The Supreme Court in *Commissioner v. Groetzinger*, *supra* at 27-32, reviewed at length the history of opinions dealing with whether individuals engaged in securities transactions were engaged in trades or businesses. The Court concluded that the tests for determining whether a gambler is in a trade or business should be the same as those applicable to a person who buys and sells securities for his own account (*i.e.*, non-dealers), where no goods or services are sold to customers. The Court recognized, and petitioner agrees fully, that an "investor", no matter how extensive or time-consuming the management of his investments, is not engaged in a trade or business. See *Higgins v. Commissioner*, 312 U.S. 212 (1941). However, in *Groetzinger* the Court (480 U.S. at 34 and n. 13) favorably acknowledged the existence of various lower court opinions holding that certain individuals who bought and sold securities for their own account were engaged in trades or businesses: *Fuld v. Commissioner*, 139 F.2d 465 (2d Cir. 1943); *Commissioner v. Nubar*, *supra*; and *Levin v. United States*, 597 F.2d 760 (Ct. Cl. 1979). In *Snyder v. Commissioner*, 295 U.S. 134, 139 n. 2 (1935), the Court had earlier favorably cited the following Board of Tax Appeals cases for their holding non-dealers to be engaged in securities trades or businesses: *Schwinn v. Commissioner*, 9 B.T.A. 1304 (1928); *Elliott*

v. Commissioner, 15 B.T.A. 494 (1929); and *Hodgson v. Commissioner*, 24 B.T.A. 256 (1931).

All six lower court cases cited by this Court in *Groetzinger* and *Snyder* as examples of individuals in a trade or business involved individuals whose livelihood was derived from capital gains generated by numerous purchases and sales of speculative securities. In all six cases, the individuals did *not* attempt to profit from short-term swings in the market; indeed, in some cases, such as *Levin* the transactions (although not appearing in the Court of Claims' opinion) produced almost exclusively long-term capital gains. See also *Fuld v. Commissioner*, *supra* (stocks acquired as early as October 9, 1930 were sold as late as 1933); *Hodgson v. Commissioner*, *supra* (stock sold in 1921 was acquired in 1920 or 1921); *Schwinn v. Commissioner*, *supra* (stock acquired in 1919 was sold in 1924). And in none of the six cases was there even the slightest suggestion that the holding period of the securities was important (much less a determinative factor) in deciding whether the individual was engaged in a trade or business. Rather, the courts in those cases distinguished the individuals engaged in trades or businesses from investors by the number of transactions they engaged in, the speculative versus conservative quality of their portfolio, and the use of margin debt.[4]

Beginning with a 1955 Tax Court case, *Liang v. Commissioner*, 23 T.C. 1040, some lower courts focused on the length of time the taxpayer held his securities as a relevant factor in determining whether a person who buys and sells securities for his own account is in a "trade or business" or is an investor. In *Liang*, the Tax Court referred to the term "trader", a colloquial term used in stock market parlance, to describe an individual who buys and sells securities "with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short term basis." 23 T.C. at 1043. The Tax Court's reference

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[4] In *Higgins v. Commissioner*, *supra*, the taxpayer maintained extensive but conservative, non-margined investments in stocks, bonds, and real estate. In the years in issue he made no sales of securities and purchased a total of only four lots of tax-exempt bonds. He was rightly held not to be in a trade or business.

to the term "trader" was not an attempt to define the statutory term "trade or business". The Tax Court merely observed that the length of holding period was one factor to consider in determining whether someone was in a trade or business.

Several lower courts have cited the Tax Court's opinion in *Liang* for the proposition that "short-swing profit" transactions are a factor in determining whether an individual is engaged in a securities trade or business. See, *e.g.*, *Moller v. United States*, 721 F.2d 810 (Fed. Cir. 1983), cert. denied, 467 U.S. 1251 (1984); *Purvis v. Commissioner*, 530 F.2d 1332 (9th Cir. 1976). However, none of these cases held that short-swing profit transactions were an indispensable requirement for trade or business status. Nevertheless, in the instant case, both the Tax Court and the Second Circuit relied upon the Tax Court's opinion in *Liang* for the proposition that, despite the fact that Yaeger satisfied all the requirements for being in a trade or business which were articulated by this Court in *Groetzinger*, he was not in a trade or business because a taxpayer can be deemed to be in a trade or business only if he seeks short-swing profits and does not realize significant income from long-term capital gains. (App., *infra*, 7a-8a, 27a-29a.) No justification is set forth by the Tax Court or the Second Circuit for rejecting the *Groetzinger* tests of trade or business and for making short-swing profit transactions an indispensable requirement for being in a trade or business, and no such requirements were imposed by the Fourth Circuit in *Commissioner v. Nubar*, *supra*, and *Adda v. Commissioner*, *supra*.

The Second Circuit's opinion — the first circuit court opinion concerning trade or business for tax purposes after *Groetzinger* — does violence to the essence of this Court's opinion in that case. That Yaeger was actively engaged full-time in buying and selling securities as his sole means of earning his livelihood is not in dispute. It should not matter whether the shares he sold were purchased one hour before they were sold or one decade before.

2. The cases favorably cited by this Court in *Groetzinger* and *Snyder* reflect the correct holding and give due deference to the tests of trade or business set forth in *Groetzinger*, without negating

the Court's holding in *Higgins*. Under these cases, an individual would be deemed to be engaged in a trade or business if his stock market activities (a) were continuous and regular, (b) required nearly all of his working hours, (c) were engaged in for profit as a primary or sole source of livelihood, (d) resulted in a substantial number of transactions each year[5], and (e) were not merely designed to preserve his assets and to earn passive income from interest and dividends.

More important than the length of holding period as a factor in determining whether one is in a trade or business is the element of risk. For example, Yaeger could have spent all of his time monitoring his portfolio of more than seven million shares held in more than 500 different companies, and he could have sought to preserve his capital by buying investment grade, blue chip stocks which paid quarterly dividends on a regular basis. If he had done so, the principles enunciated by this Court in *Higgins v. Commissioner, supra*, would apply, and Yaeger would not be considered to be in a trade or business no matter how active or time-consuming the management of his portfolio. However, in this case Yaeger was not merely monitoring the performance of his portfolio on a full-time basis; he was buying and selling securities nearly every day the stock market was open for business. Yaeger was not merely managing his portfolio to preserve his capital, as an investor would do; he was buying primarily speculative stocks and increasing his risk exponentially by borrowing to the maximum extent generally permitted, in order to finance his securities activities. Yaeger did not seek to earn interest and dividends from his portfolio; in each of the years 1979 and 1980 his margin interest expense exceeded his dividend and interest income by more than $3,500,000.

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[5] An average of approximately one transaction every other business day (or about 100 per year) would seem to qualify as substantial under the reported cases. Yaeger executed more than 1,000 transactions in each of the years 1979 and 1980, an average of four transactions for each day the stock markets were open for business. (App., *infra*, 19a.) It should be noted that an active trader such as Yaeger probably placed at least one order for purchase or sale of securities which did not get executed for each order which was executed.

The Second Circuit has misapplied the legislative history of section 163(d). The circuit court cites a passage from the legislative history in 1969, when section 163(d) was enacted, to support its conclusion that a deduction for interest should not be allowed to offset long-term capital gain income. However, the legislative history could not possibly support that conclusion because section 163(d), as first enacted, specifically allowed investment interest to be fully deducted against long-term capital gains. Section 221(a), Tax Reform Act of 1969, Pub. L. No. 91-172. The circuit court erroneously postulated as an "abuse" cured by section 163(d) a deduction which that section specifically allowed.

Section 163(d) was enacted because Congress was concerned that investment interest expenses in excess of investment income could be used to shelter taxpayers' income from other sources, such as salary or other "earned income". S. Rep. No. 552, 91st Cong., 1st Sess. 305-306 (1969); H.R. Rep. No. 413, 91st Cong., 1st Sess., pt 1, at 72-73 (1969). Congress, therefore, provided in section 163(d) that the deduction for investment interest expense would be "matched" with income from investment assets, including long-term and short-term capital gain. Since Yaeger earned no income in 1979 or 1980 other than from his securities (except a nominal $10,600 director's fee), the application of the section 163(d) limitation in this case does not serve the purpose contemplated by Congress of not allowing investment interest expense to reduce "earned income".

When it enacted section 163(d) in 1969, Congress made clear that the deduction for interest expense incurred in a trade or business would not be limited by section 163(d). H.R. Rep. No. 413, *supra* at 73. Congress provided this exception to the interest expense limitation of section 163(d) in recognition of the fact that all expenses incurred in a trade or business, whether they be interest expenses or any other expenses, were (and are) allowed in full to offset all income recognized by a taxpayer, regardless of the source of the income or of its character as ordinary income or capital gain.

In 1976 Congress eliminated long-term capital gains from the list of income items against which investment interest expense

was deductible. Section 209, Tax Reform Act of 1976, Pub. L. No. 94-455. This modification of section 163(d) was made in the House-Senate Conference and has never been explained as directed to any particular abuse. Indeed, neither the House nor Senate versions of the bill prior to Conference contained any such limitation. H.R. Rep. No. 658, 94th Cong., 1st Sess. 102-106 (1976); S. Rep. No. 938, 94th Cong., 2d Sess. 106-107 (1976); H.R. Conf. Rep. No. 1515, 94th Cong., 2d Sess. 417-418 (1976). Significantly, Congress retained without any change whatsoever the exception in the statute for interest incurred in a trade or business, and the legislative history of the 1976 Act reaffirms Congress' intent to continue to allow interest expense incurred in a trade or business as a deduction in full to offset all income reported by a taxpayer, both ordinary income and capital gain. H.R. Rep. No. 658, *supra* at 103-104.

In sum, since section 163(d), as enacted in 1969, allowed all interest expense to be deducted against long-term capital gain, nothing in that provision supports narrowing the definition of "trade or business" under section 163(d) to differentiate between long-term and short-term gains. And, since Congress did not change in any way the "trade or business" exception to section 163(d) in 1976, there is no basis for the courts to impose a restricted definition of trade or business to take effect in 1976.

Thus, the short-term swings requirement for being in a trade or business which was imposed by the Second Circuit is neither dictated by, nor even suggested by the legislative history of, section 163(d), as enacted in 1969 or amended in 1976. In imposing the short-term swings requirement, the lower courts are imposing their own value judgments as to how they believe interest expense should be treated, instead of accepting what Congress legislated. Congress provided that interest incurred in a trade or business is deductible without limitation. Nevertheless, the lower courts, in order not to allow interest expense ever to offset long-term capital gains, are attempting to redefine and greatly restrict what constitutes a trade or business so that if a taxpayer's business results primarily in long-term capital gain, it is not considered a trade or business for Federal income tax purposes.

Yaeger should be treated as engaged in a securities trade or business in 1979 and 1980 because he satisfied the tests enunciated by this Court in *Groetzinger* and because allowing the deduction is exactly what Congress provided in section 163(d): interest expense is matched with the income generated by the expense. Further, the cases cited by this Court in *Groetzinger* and *Snyder* as examples of persons in a trade or business provide a logical basis for determining what constitutes a trade or business – one with parallels in other areas of business. For example, an antiques or art dealer who, full-time and for his livelihood, continually buys and sells objects or paintings (even though they remain in inventory for years and benefit from the general rise in price for such objects or paintings) is no doubt engaged in a trade or business. In contrast, an antiques or art "investor", who rarely buys or sells objects or paintings and has other sources of livelihood, is clearly not engaged in a trade or business. No one would seriously contend that an antiques or art dealer was not engaged in a trade or business simply because he held his inventory for a long time so that his primary income derived from the increase in value of particular objects or works of art over time, rather than from the merchant's mark-up from wholesale to retail.

3. It is not possible for a taxpayer to estimate the revenue impact of the Second Circuit's decision. However, the importance of the issue presented is one of national scope – potentially affecting all individuals who purchase and sell securities for their own accounts.

Further, the Second Circuit's opinion will have an even more adverse and anomalous impact under the law applicable today than it has with respect to the years 1979 and 1980. Individuals who, like Yaeger, engage in full-time securities speculation for a livelihood may incur, in addition to interest, office expenses such as rent, equipment rental, postage, etc. If they are treated as engaged in a trade or business, they would be allowed a deduction for these expenses under section 162 (ordinary and necessary business expenses) in computing their regular tax liability (*i.e.*, the liability imposed by section 1) or their alternative minimum

tax liability (*i.e.*, the liability imposed by section 55). The same individuals might not be able to deduct these expenses (or would have their deductions significantly limited) if they were not treated as engaged in a trade or business, because such expenses would then fall within the ambit of section 212 (expenses incurred for the production of income). Under current law, section 212 deductions are treated as miscellaneous itemized deductions which are deductible in computing regular tax liability only to the extent that the aggregate of all miscellaneous itemized deductions exceeds 2 percent of adjusted gross income. Section 67. Further, under current law, section 212 deductions are not deductible to any extent in computing alternative minimum tax. Section 56(b)(1)(A). Accordingly, the issue of who is engaged in a trade or business as presented in this case applies to more than the investment interest expense limitation of section 163(d).

What follows from the judicial tax law making in this case is a series of irrational results: (1) a taxpayer like Yaeger, whose sole source of livelihood is derived from the active buying and selling of securities, is taxed on his gross long-term gains, and he never has an opportunity to deduct his interest expense unless he changes his business activities to focus on short-term gains; (2) although Congress in 1986 eliminated the tax rate differential between long-term and short-term capital gains, the result legislated by the lower court creates and retains, even under current law, a distinction between long-term and short-term holding periods for the purpose of determining whether a taxpayer is engaged in a trade or business; and (3) under current law a taxpayer who derives his livelihood as Yaeger did, and who incurs office expenses such as rent, office equipment, postage, etc., could not deduct all of his expenses but would be required to report these expenses as miscellaneous itemized business deductions which can be deducted against regular tax only to the extent they exceed 2% of his adjusted gross income, and which cannot be deducted at all in determining the alternative minimum tax. The result of the circuit court's opinion is that a person who plays the horses for a living is treated better for tax purposes than an individual who derives his livelihood from buying and selling stocks.

This Court has never squarely addressed the status under the tax law of individuals who are not dealers in securities but who are nevertheless engaged in securities trades or businesses. Given the importance of this question, this is an area where the Court should lay down a uniform, rational rule.

B. *Second Question Presented — Tax Court's Jurisdiction.*

The issue of the Tax Court's jurisdiction presents an important question of Federal tax law. The decision below (a) is in direct conflict with the provisions of the Internal Revenue Code which carefully define the jurisdiction of the Tax Court, (b) is at odds with the fundamental principles that this Court enunciated in *Commissioner v. Gooch Milling & Elevator Co.*, 320 U.S. 418 (1943), and (c) upsets the entire statutory scheme for assessing and collecting income tax.

The decision below produces a dangerous result by permitting the Commissioner to change the tax year at issue in the Tax Court by simply informing the taxpayer that he intended to determine a deficiency with respect to a tax year different from the one set forth in the notice of deficiency. Given the tens of thousands of notices of deficiency that are issued by the Commissioner each year, this Court should review the decision below and make clear the jurisdiction of the Tax Court.

1. The jurisdiction of the Tax Court to determine a taxpayer's income tax is specifically set forth in the Internal Revenue Code. Pertinent sections of the Internal Revenue Code are set forth in the statutory appendix. (App., *infra*, 37a-39a.) The Tax Court is granted jurisdiction to determine the correct income tax for a tax year if (1) the Commissioner issues a notice of deficiency to the taxpayer for that tax year, *and* (2) the taxpayer files a timely petition with the Tax Court seeking a redetermination of the tax liability for that year. Sections 6213(a) and 6214(a). The Internal Revenue Code specifically provides that the Tax Court "shall have no jurisdiction to determine whether or not the tax for any other year . . . has been overpaid or underpaid." Section 6214(b). Notwithstanding the statutory provisions, the Second Circuit has

granted the Tax Court jurisdiction to determine the tax liability for a tax year which is not mentioned in the notice of deficiency or in any of the pleadings filed with the Tax Court.

In the instant case, the Commissioner issued a notice of deficiency to the Estate for the taxable year ended December 31, 1981 and the Estate petitioned the Tax Court in an effort to contest the deficiency for the calendar year 1981. Several years after the pleadings had been filed, the Estate's newly engaged attorney determined (a) that the Estate had not filed a tax return for any period ending December 31, 1981 (the Estate had filed a return for Yaeger's income for the short taxable year which ended on the date of his death [*i.e.*, January 1, 1981 through May 11, 1981] and another return for the Estate's first fiscal year [*i.e.*, May 11, 1981 through April 30, 1982]), (b) that the petition filed with the Tax Court by the Estate placed the calendar year 1981 in issue, and (c) that the Commissioner's answer agreed with the Estate's petition concerning the year at issue. Accordingly, the Estate's attorney moved the Tax Court to dismiss the year 1981 for lack of jurisdiction. The Tax Court granted the Estate's motion.

The Second Circuit reversed and held that the Tax Court has jurisdiction to determine a deficiency for Yaeger's taxable year January 1, 1981 through May 11, 1981, despite the facts that the notice of deficiency issued by the Commissioner referred only to the year ending December 31, 1981, and the pleadings filed by the Estate and the Commissioner placed only the calendar year 1981 in issue. The Second Circuit indicated that an objectively reasonable taxpayer should have been able to infer from analyzing the schedules attached to the notice and comparing them to possible tax returns involved that the Commissioner intended the notice to apply to the taxable year ended May 11, 1981. (App., *infra*, 11a-14a.)

2. In *Commissioner v. Gooch Milling & Elevator Co.*, *supra*, this Court had occasion to declare that the jurisdiction of the Board of Tax Appeals – the predecessor of the Tax Court – was purely statutory, that the Board had no equitable powers (*e.g.*, to grant equitable recoupment), and that the Board was "impotent" to "determine the overpayment or underpayment in any taxable year

other than the one for which a deficiency has been assessed." *Id.* at 422. This Court has never, however, had occasion to consider what are the necessary contents of a valid notice of deficiency, or whether the Tax Court or an appellate court possesses the equitable power to reform a notice of deficiency so as to confer jurisdiction to determine a deficiency for a tax year which is not referred to in the notice of deficiency or in the pleadings.

Lower courts have long held that the Commissioner is not obligated to provide a detailed explanation in his deficiency notice. *Barnes v. Commissioner*, 408 F.2d 65 (7th Cir. 1969), cert. denied, 396 U.S. 836 (1969); *Jarvis v. Commissioner*, 78 T.C. 646 (1982). However, it is clear, as the Second Circuit acknowledges in its opinion below(App., *infra*, 11a), that four items must be accurately set forth in a notice of deficiency for the statutory scheme to work: (1) the name of the taxpayer, (2) the taxable year involved, (3) the amount of the deficiency proposed, and (4) a statement that the notice is a notice of deficiency. *Scar v. Commissioner*, 814 F.2d 1363, 1367 (9th Cir. 1987).

Upholding as valid a notice of deficiency which fails to set forth an accurate taxable year and allowing the Tax Court to have jurisdiction over a tax year not set forth in the notice of deficiency totally frustrates the procedural safeguards adopted by Congress and creates a potential for confusion and abuse in the assessment and collection of income taxes. First, the tax year set forth in the notice and in the Tax Court petition defines the limited scope of the Tax Court's jurisdiction under sections 6214(a) and 6512(b). Second, the tax year set forth in the notice is the only one for which the Service is allowed to assess and collect a tax, which it will do if the taxpayer does not timely file a petition with the Tax Court. Section 6213(a). Third, when a petition is filed in response to a notice of deficiency, the Commissioner is barred from sending additional deficiency notices relating to the same taxable year. Section 6212(c)(1). Fourth, the tax year set forth in the notice is employed by the Internal Revenue Service to determine the filing date of a return, which is the date from which interest is calculated and charged after the assessment is made. Section 6601(a). Finally, the issuance of a notice

of deficiency tolls the statute of limitations for assessing and collecting the tax for the tax year set forth in the notice. Section 6503(a). If the Commissioner is allowed to claim that a notice of deficiency which sets forth one taxable year (whether or not it was a proper year) was intended to relate to another taxable year, and if by so doing he is permitted to assess a tax for a year not set forth in the notice of deficiency, all the foregoing procedural safeguards will be negated.

It is not satisfactory to say, as the Second Circuit does, that the taxpayer is not harmed when an incorrect year is set forth in a notice because the taxpayer is still afforded the opportunity to litigate. (App., *infra*, 12a.) The taxpayer is entitled to repose and *not* to litigate. This is particularly true where, as in this case, the taxpayer is being forced to litigate a tax year which is raised by the Commissioner for the first time after the statute of limitations for issuing a proper notice of deficiency for that year has expired.[6]

3. The Second Circuit ignores the fact that there is nothing in the case to confer jurisdiction on the Tax Court over the year ended May 11, 1981. That date is not mentioned either in the notice of deficiency, in the Estate's Tax Court petition, or in the Commissioner's answer. The Second Circuit's opinion would confer jurisdiction on the Tax Court based not on what is said in the notice of deficiency or in the pleadings, but on what the Commissioner intended, but did not state, in his notice of deficiency.

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[6] The Commissioner never formally notified the Estate that he intended the notice of deficiency to cover the tax year ended May 11, 1981. The only notification from the Commissioner came in his response to petitioner's motion to dismiss the tax year 1981, which was after the statute of limitations for assessing a tax for the year ended May 11, 1981 had expired (more than 3 years after the return for that year was filed). See section 6501(a). The Commissioner never sought to correct his erroneous notice of deficiency or to amend his answer to set forth a proper tax year. The Commissioner could have sent a corrected notice for the tax year ended May 11, 1981 long before the statute of limitations had expired as to that year. That he did not do so is his own fault. Indeed, the Commissioner appears to be determined not to correct his records. As recently as November 1989, he sent (albeit improperly) collection notices to the Estate for the tax year ended December 31, 1981.

Such a result is directly contrary to section 6214(b), emasculates the principles set forth by this Court in *Gooch Milling* concerning the jurisdiction of the Tax Court, and negates the procedures set forth by Congress in the Internal Revenue Code which are designed to protect taxpayers as well as the government. We are left with the unanswered question: What is the statutory basis upon which the Tax Court obtains jurisdiction in this case to determine a deficiency for the tax year ended May 11, 1981?

The Second Circuit's holding – that a notice of deficiency is valid as to any taxable year if, by referring to items outside the notice (*e.g.*, tax returns), a taxpayer could guess the taxable year as to which the Commissioner intended to determine a deficiency – is not workable. Many taxpayers do not retain copies of their tax returns, but request copies from the Commissioner in the course of Tax Court litigation. It usually takes the Commissioner many months to locate such returns in his files. Such taxpayers should not be forced to choose between allowing the Commissioner to assess and collect a tax for an unknown year or petitioning the Tax Court in order to find out what tax year is involved.

The Tax Court correctly held that it lacked jurisdiction in this case. Its determination in this case to limit its own jurisdiction is entitled to considerable deference in this matter. The notice of deficiency is valid only for the tax year set forth in the notice. If that year is not a proper tax year, then the notice of deficiency is not valid. The Tax Court (App., *infra*, 33a) relied on its own precedent in *Century Data Systems, Inc. v. Commissioner*, 80 T.C. 529 (1983). In *Century Data*, the taxpayer kept its books on a calendar year, and thus its correct taxable years ended on December 31 of each year. When the Commissioner issued notices of deficiency for the taxable years ended June 30, 1970 and June 30, 1971, the Tax Court held the notices of deficiency invalid for failure to state a correct taxable year and dismissed the case for lack of jurisdiction. The Tax Court stated:

> [W]here the statutory notice describes an incorrect taxable year composed of some portion of each of 2 correct taxable years, the notice is inherently erroneous

> because the deficiency asserted has necessarily omitted items of income and deduction of the correct taxable year and has included other items which properly belong in another taxable year. [80 T.C. at 534-535.]

Accord *Atlas Oil & Refining Corp. v. Commissioner*, 17 T.C. 733 (1951).

4. It is not possible for the Estate to know how many notices of deficiency set forth an erroneous taxable year, and the revenue impact of the issue in this case is beyond the Estate's power to estimate. Nevertheless, the issue presented in this case is extremely important, as it potentially affects every taxpayer in the United States. Tens of thousands of notices of deficiency are issued annually involving, in aggregate, billions of dollars of asserted deficiencies. This case presents an appropriate opportunity for this Court to enunciate the scope of the Tax Court's jurisdiction and the necessary contents of a valid notice of deficiency.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

RICHARD A. LEVINE*
CARLTON M. SMITH
SIDNEY I. ROBERTS**

ROBERTS & HOLLAND
30 Rockefeller Plaza
New York, NY 10112
(212) 903-8700

Counsel for Petitioner

* *Counsel of Record*
** *Of Counsel*

January 31, 1990

APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Nos. 89-4045, 89-4059

ESTATE OF LOUIS YAEGER, DECEASED, JUDITH WINTERS, RAPHAEL MEISELS, ABRAHAM K. WEBER, AND THE BANK OF NEW YORK, EXECUTORS,

Petitioner-Appellant, Cross-Appellee,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee, Cross-Appellant.

APPEAL FROM A DECISION OF THE
UNITED STATES TAX COURT

Argued August 29, 1989 — Decided November 7, 1989

Before: FEINBERG and NEWMAN, Circuit Judges, and MISHLER, Senior District Judge.*

MISHLER, District Judge. Petitioner appeals from a decision and order of the tax court, unofficially reported at 55 T.C.M. (CCH) 1101 (1988) (Wright, J.), that found that Louis Yaeger, deceased, was not in the trade or business of trading in securities and, therefore, that the interest he incurred in buying securities

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* Honorable Jacob Mishler, Senior United States District Judge for the Eastern District of New York, sitting by designation.

on margin was "investment interest" within the meaning of 26 U.S.C. section 163(d) and ordered that there is a deficiency due from the taxpayer for taxable years 1979 and 1980.[1] Respondent cross-appeals an unreported order of the tax court that granted the estate's motion to dismiss its petition for lack of jurisdiction as to the 1981 taxable year because the notice of deficiency set forth an incorrect taxable year.[2]

We affirm the tax court's order that there is a deficiency due from the taxpayer for taxable years 1979 and 1980. We reverse the order that dismissed so much of the petition that referred to tax year ending December 31, 1981 for lack of jurisdiction and remand for a trial on the issue of Yaeger's tax liability for the portion of the 1981 tax year ending May 11, 1981.

I. TRADE OR BUSINESS OF TRADING IN SECURITIES

A. *Background*

The facts as stipulated and found by the tax court are not in dispute.[3] Yaeger graduated Phi Beta Kappa from Columbia University in 1921 having studied business and finance. Upon graduation he went to work as an accountant and subsequently became employed as an auditing agent for the Internal Revenue Service. He left this employ in 1923 and went to work as a bond salesman in New York City, eventually becoming an investment counselor.

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[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.) as amended and in effect during the years in issue.

The Internal Revenue Code has since been redesignated as the Internal Revenue Code of 1986. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 2, 100 Stat. 2085.

[2] The commissioner's earlier appeal from that order was dismissed as premature by this court in an opinion reported at 801 F.2d 96 (1986). Since a final decision has been rendered regarding the remaining taxable years, the commissioner's appeal is ripe for decision. *See Id.* at 98.

[3] We follow the tax court in noting that we use such words as "speculate," "trade," "invest," and similar terms for convenience and without intending any inference as [to] the tax characterization or consequences of the facts.

Commencing in the mid-1920s, Yaeger began actively trading stocks and bonds on the stock market on his own account in addition to conducting his investment consulting business. In the 1940s, Yaeger gave up his investment consulting business because the management of his own account had grown so demanding. Thereafter, he devoted himself exclusively to trading on his own account, which was his sole occupation until the day he died.

Prior to 1979, Yaeger maintained accounts with several brokerage firms in New York, including H. Hentz & Co. His account at H. Hentz & Co. was the largest account that firm had maintained for a United States citizen. During the period between 1979 and his death, Yaeger maintained accounts with three brokerage firms and occasionally dealt with two others.

The following chart describes the trading activity in Yaeger's various accounts throughout the years in issue:

Year	*Purchase Transactions*	*Sales Transactions*	*Number Shares Bought*	*Number Shares Sold*
1979	1,176	86	1,453,555	822,955
1980	1,088	39	1,658,841	173,165

Yaeger maintained an office at H. Hentz & Co. from which he conducted most of his trading activity. For a brief period of time he also conducted his activity from another brokerage firm. H. Hentz & Co. provided Yaeger with an assistant, a telephone, use of the secretarial pool, and access to the research staff and facilities. Yaeger spent a full day at his office, researching investment opportunities and placing orders, and then returned home to read more financial reports late into the night. He worked every day of the week. When he was out of town, he maintained telephone contact with the brokers who handled his accounts. Yaeger was trading on the stock market the day before he died.

Yaeger subscribed to a distinct investment strategy. His trading strategy was to buy the stock of companies in which the stock prices were extremely undervalued and hold the stock until it reached a price that reflected the underlying value of the company. He rarely purchased "blue chip" stocks and many of the stocks he held did not pay dividends. Instead, Yaeger constantly looked for companies that were experiencing financial distress but whose underlying value was not recognized.

This strategy required thorough research that extended beyond the study of mainstream publications. He also poured (sic) over annual reports and brokerage house reports. Once Yaeger determined that the targeted company was experiencing temporary difficulties, he began to accumulate the stock. He would buy stock as it became available, although some of the stock was not frequently or actively traded and was difficult to acquire. He would initially buy small quantities of stock to avoid attracting attention from other investors. Once he obtained a sizeable amount of stock he would let his position be known. Yaeger took whatever steps he thought necessary to improve the position of the companies in which he invested, often supplying unsolicited business advice to the managers and occasionally attempting to arrange mergers or acquisitions.*

In addition to selecting financially troubled companies in which to invest, Yaeger increased his gain on his investments by using margin debt. Yaeger financed his purchases by borrowing to the maximum extent allowable under law and the custom of the brokerage houses, which was generally 50 percent. If the value of his stock rose he would use that increased

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* Yaeger's investment strategy produced some startling successes. For example, in 1980 Yaeger invested in Seton Company upon reading in an annual report footnote that one of its divisions had discovered a material that could be used as artificial skin. Years later, the value of the formerly unprofitable stock rose dramatically as the company shifted to manufacturing artificial skin. Similarly, Yaeger purchased bonds issued by the New York, New Haven and Hartford Railroad while the company was in bankruptcy. After the company was reorganized as Penn Central Corporation, Yaeger realized a substantial profit on the bonds.

value as equity to support more debt. From time to time Yaeger shifted accounts from one brokerage house to another in order to maximize the volume of margin debt he could carry. Once or twice during his career Yaeger was overleveraged and suffered substantial losses when he was forced to sell enough stock to maintain his margin debt.

During the years 1979 and 1980, the ratio of Yaeger's margin debt to portfolio value was 47 percent and 42 percent, respectively. Yaeger's total stock market related debt equalled $42,154,048 in 1979 and $54,968,371 in 1980. When he died, his portfolio was subject to debt in the amount of $70,490,018.

In 1979 and 1980 Yaeger reported income in the following amounts on his federal tax return:

1979	*Character of Income*	*Amount*
	Long-term capital gain	$13,839,658
	Short-term capital gain	184,354
	Dividends	2,339,080
	Interest	57,958
		$16,421,050

1980	*Character of Income*	*Amount*
	Long-term capital gain	$1,099,921
	Short-term capital gain	728,404
	Dividends	3,648,441
	Interest	91,717
	Director's fees	10,600
		$5,579,083

Of the stock which Yaeger sold in taxable years 1979 and 1980, the percentage of total sales of securities which he had held for twelve months or more was 88 percent and 91 percent, respectively. The purchase dates of the securities sold in 1980 ranged from March 1970 to December 1979. In 1979, Yaeger did not sell any security that had been held for less than three months

and, in 1980, did not sell any security that had been held for less than six months. On schedule C of the tax returns, Yaeger deducted interest expense in 1979 and 1980 in the amounts of $5,865,833 and $7,995,010, respectively.

The sole issue considered by the tax court was whether the claimed deductions of the interest expenses Yaeger incurred in purchasing securities on margin were subject to the limitation on the deductibility of investment interest set forth in section 163(d).[5] This issue turned on whether Yaeger's stock market activities constituted investment activity or the activity of trading in securities as a trade or business. According to the tax court, the "pivotal inquiry" was "whether Yaeger was interested in deriving income from capital appreciation or from short-term trading." The court determined that Yaeger was an investor, not a trader, because Yaeger held his stocks and bonds for lengthy periods of time anticipating that they would appreciate in value. Thus, the interest expense he incurred was "investment interest" within the meaning of section 163(d) and subject to the deductibility restrictions of that section.

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[5] Section 163(d) provided in pertinent part:

(1) In general.—In the case of a taxpayer other than a corporation, the amount of investment interest (as defined in paragraph (3)(D)) otherwise allowable as a deduction under this chapter shall be limited, in the following order, to —

(A) $10,000 . . ., plus

(B) the amount of the net investment income . . ., plus the amount (if any) by which the deductions allowable under this section . . . and sections 162, 164(a)(1) or (2), or 212 attributable to property of the taxpayer subject to a net lease exceeds the rental income produced by such property for the taxable year. . . .

[(3)](D) Investment Interest.

The term "investment interest" means interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment.

B. *Discussion*

Section 163 of the Internal Revenue Code generally provides for the deduction of interest incurred on indebtedness. As defined in section 163(d)(3)(D), "investment interest" is "interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment." Section 163(d) limits the deductibility of investment interest by a noncorporate taxpayer to the extent of the taxpayer's investment income, plus $10,000. Any amount disallowed is "treated as investment interest paid or accrued in the succeeding taxable year." 26 U.S.C. § 163(d)(2). Section 163(d) does not apply to interest paid to buy property for personal use or property for trade or business use. *See* H.R. Rep. 413, pt. 1, 91st Cong., 1st sess. 72, *reprinted in* 1969 U.S. Code Cong. & Admin. News 1645, 1719 ("interest on funds borrowed in connection with a trade or business would not be affected by the limitation").

The Internal Revenue Code does not define "trade or business." Determining whether a taxpayer's trading activities rise to the level of carrying on a trade or business turns on the facts and circumstances of each case. *Higgins v. Commissioner*, 312 U.S. 212, 217 (1941). In determining whether taxpayers who manage their own investments are traders, "relevant considerations are the taxpayer's investment intent, the nature of the income to be derived from the activity, and the frequency, extent, and regularity of the taxpayer's securities transactions." *Moller v. Commissioner*, 721 F.2d 810, 813 (Fed. Cir. 1983), *cert. denied*, 467 U.S. 1251 (1984).

Investors are engaged in the production of income. *Purvis v. Commissioner*, 530 F.2d 1332, 1334 (9th Cir. 1976). Traders are those "whose profits are derived from the 'direct management of purchasing and selling.' " *Moller, supra*, at 813 (quoting *Levin v. United States*, 597 F.2d 760, 765 (Ct. Cl. 1979)). Investors derive profit from the interest, dividends, and capital appreciation of securities. *See Moller, supra*, at 813; *Purvis, supra*, at 1334; *Liang v. Commissioner*, 23 T.C. 1040, 1043 (1955). They are "primarily interested in the long-term growth potential of their stocks." *Id.* Traders, however, buy and sell securities "with

reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short term basis." *Purvis, supra*, at 1334 (quoting *Liang v. Commissioner*, 23 T.C. 1040, 1043 (1955)).

Thus, the two fundamental criteria that distinguish traders from investors is (sic) the length of the holding period and the source of the profit. These criteria coincide with the congressional purpose behind the enactment of section 163(d), which originated in the Tax Reform Act of 1969, Pub. L. No. 91-172, § 221, 83 Stat. 487. Congress was concerned with the prevalent use of borrowed money to purchase investment assets and the distortion of taxable income that often results when the investments produce long-term capital gain rather than ordinary income.[6] As explained in the House Report accompanying the 1969 Act:

> The itemized deduction presently allowed individuals for interest makes it possible for taxpayers to voluntarily incur substantial interest expense on funds borrowed to acquire or carry investment assets. Where the interest expense exceeds the taxpayer's investment income, it, in effect, is used to insulate other income from taxation. For example, a taxpayer may borrow substantial amounts to purchase stocks which have growth potential but which return small dividends currently. Despite the fact that receipt of the income from the investment may be postponed (and may be capital gains), the taxpayer will receive a current deduction for the interest expense even though it is substantially in excess of the income from the investment.

H.R. Rep. 413, *supra*, at 73.

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[6] For example, "[a] much publicized study of 154 high income individuals who paid little or no Federal income taxes found that 72 of these individuals benefitted by deducting interest paid on loans taken to acquire growth stock and similar investments the gains on which would constitute capital gains." *Miller v. Commissioner*, 70 T.C. 448, 453 n.3, (citing H. R. Rep. No. 413, pt. 1 (1969); 115 Cong. Rec. 22,563, 22,760 (Statement of Rep. Mills), 22,573 (Statement of Rep. Byrnes) (1969)).

The activity of holding securities for a length of time to produce interest, dividends, and capital gains fits the abuse targeted by section 163(d): investing for postponed income and current interest deduction.

The tax court properly concluded that Yaeger was an investor. It is true that Yaeger initiated over 2000 securities transactions in 1979 and 1980 and pursued his security activities vigorously and extensively. And there is no doubt, as the tax court stated, that Yaeger "maintainend a margin of debt which would have caused a more faint-hearted investor to quail." However, "[n]o matter how large the estate or how continuous or extended the work required may be," the management of securities investments is not the trade or business of a trader. *Higgins, supra*, at 218.[7]

More importantly, most of his sales were of securities held for over a year. He did not sell any security held for less than three months. He realized a profit on the securities through both dividends and interest. Most of his profit, however, came from holding undervalued stock until its market improved. This emphasis on capital growth and profit from resale indicates an investment motivated activity. *See Miller v. Commissioner*, 70 T.C. 448, 457 (1978). In addition, since the income came from long-term appreciation, Yaeger would receive the benefit of favorable capital gains treatment. To disregard the nature of the income and length of his holdings simply because Yaeger was a vigorous investor would defeat the purpose of section 163(d).[8]

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[7] *See also Groetzinger v. Commissioner of Internal Revenue*, 771 F.2d 269, 275 (7th Cir. 1985) ("The fact that one person has accumulated more wealth than another . . . so that passive investment may command substantially more of the wealthier person's time and attention than that of a poorer counterpart, would not justify allowing the wealthier taxpayer the benefit of trade or business treatment. . . ."), *aff'd*, 480 U.S. 23 (1987).

[8] Our prior decision in *Fuld v. Commissioner*, 139 F.2d 465 (2d Cir. 1943), is not to the contrary. In that case we upheld a tax court determination that the taxpayers were traders and did so on evidence that the taxpayers had made a large number of sales of securities held for less than two years.

II. NOTICE OF DEFICIENCY

A. *Background*

After Yaeger's death on May 11, 1981, form 1040 was filed on his behalf for the short period January 1, 1981 through May 11, 1981. As a new taxpayer, the estate elected April 30 as its fiscal year end and subsequently filed form 1041 for the period May 11, 1981 to April 30, 1982.

On April 15, 1983, the tax commissioner issued two notices of deficiency directed to the estate. The first notice specified deficiencies for tax years ending December 31, 1979 and December 31, 1980. The second notice specified a deficiency for tax year ending December 31, 1981. Both notices were accompanied by a waiver form; a statutory notice statement, which explains the adjustments; a statement of income tax changes; an explanation of the adjustments made in these changes; a corrected investment interest expense deduction form (form 4952); and a corrected alternative minimum tax computation form (form 5251). Computations illustrating the corrections accompanied the latter two forms.

Yaeger's estate filed a petition in the tax court on July 15, 1983, seeking a redetermination of the deficiencies. In late October, the estate moved the tax court to dismiss for lack of jurisdiction so much of the petition that referred to the calendar year ending December 31, 1981. The basis of the motion was that the notice was invalid since it referred to neither tax year ending May 11, 1981 nor tax year ending April 30, 1982. The tax court granted the estate's motion, noting that its jurisdiction depended upon the commissioner's issuance of a notice of deficiency. 26 U.S.C. § 6214(a), Rule 13(a), Tax Court Rules of Practice and Procedure. The tax court also noted that any error in the notice relating to the tax year would be ignored if the taxpayer was not misled. However, since both the first page and appended computations showed the same wrong year, the tax court found that the estate was unable to determine which taxable year was referred to in the notice.

B. *Discussion*

The statutory notice of deficiency is often referred to as the taxpayere's "ticket to the tax court." *Corbett v. Frank*, 293 F.2d 501, 502 (9th Cir. 1961); *Midland Mortgage Co. v. Commissioner*, 73 T.C. 902, 905 (1980); *Baron v. Commissioner*, 71 T.C. 1028, 1034 (1979). It affords the taxpayer the opportunity to file a petition with the tax court and seek a redetermination of the deficiency. 26 U.S.C. § 6213(a). The commissioner cannot assess, levy, or begin collection proceedings until the notice has been mailed; until the expiration of the taxpayer's time to bring a petition; and, if a petition is brought, until the tax court has made a determination. 26 U.S.C. § 6213(a). Once the petition is brought, the tax court has "jurisdiction to redetermine the correct amount of the deficiency." 26 U.S.C. § 6214(a).

The statute does not specify the form or content of the notice. The purpose of the notice "is only to advise the person who is to pay the deficiency that the Commissioner means to assess him; anything that does this unequivocally is good enough." *Olsen v. Helvering*, 88 F.2d 650, 651 (2nd Cir. 1937) (Hand, L., J.). Thus, the notice generally must indicate that a deficiency has been determined and identify the taxpayer, the taxable year involved, and the amount of the deficiency. *See, e.g., Scar v. Commissioner*, 814 F.2d 1363, 1367 (9th Cir. 1987), *rev'g on other grounds* 81 T.C. 855 (1983); *Abrams v. Commissioner*, 787 F.2d 939, 941 (4th Cir.), *cert. denied*, 479 U.S. 882 (1986); *Benzvi v. Commissioner*, 787 F.2d 1541, 1542 (11th Cir.), *cert. denied*, 479 U.S. 883 (1986); *Foster v. Commissioner*, 80 T.C. 234 (1983), *aff'd in part and vacated in part*, 756 F.2d 1430 (9th Cir. 1985), *cert. denied*, 474 U.S. 1055 (1986). In short, "[t]he notice must meet the general 'fairness' requirements of due process." *Planned Investments, Inc. v. United States*, 881 F.2d 340, 344 (1989) (6th Cir. 1989).

Likewise, mistakes in the content of the notice "which do not frustrate its purpose, are negligible." *Olsen v. Helvering, supra*, at 651 (Hand, L., J.). The test for determining whether the notice's purpose was accomplished is whether the taxpayer

reasonably knew or should have known that the deficiency notice was directed to the taxpayer, that a deficiency determination was made, the taxable year involved, and the amount of the deficiency. This objective standard focuses on whether the taxpayer was justifiably misled or deceived by a mistake in the notice. Thus, "[n]otices containing technical defects are valid where the taxpayer has not been prejudiced or misled by the error and is afforded a meaningful opportunity to litigate" the claims.[9] *Planned Investments, Inc. v. United States*, *supra*, at 343 (Penalty assessment notice failed to specify time period involved; held adequate because taxpayer knew from prior dealings with IRS "exactly what the charged conduct was and when it occurred."). *See Sanderling, Inc. v. Commissioner*, 571 F.2d 174, 176 (3rd Cir. 1978) (Since notice covered a time longer than proper period and transaction occurred before end of proper taxable year, taxpayer not misled as to proper year and amount in controversy.); *Wood Harmon Corporation v. United States*, 206 F. Supp. 773, 777 (1962) (Incorrect date on assessment notice was disregarded since there was no evidence that the taxpayer was "misled by the description of the taxable period."), *aff'd*, 311 F.2d 918 (2nd Cir. 1963); *Commissioner v. Forest Glen Creamery Co.*, 98 F.2d 968, 971 (7th Cir. 1938) (Deficiency notice "either must state the taxable period" or "give enough information that the taxpayer reasonably could not be deceived as to the taxable period.").

The taxpayer must demonstrate that the notice was misleading. In addition, although the commissioner is not required to indicate the basis for the deficiency determination, *see Barnes v. Commissioner*, 408 F.2d 65, 68 (7th Cir.), *cert. denied*, 396 U.S. 836 (1969), any statements or computations

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[9] The estate notes that the commissioner "is not willing to overlook defects in setting forth the taxable year when the shoe is on the other foot." Pet. brief at 42. The tax court has held that a taxpayer could not amend the petition to include omitted years after the ninety-day time limit even when the notices of deficiency for the omitted years were attached to the petition. 26 U.S.C. § 6213(a). *See, e.g., Frazee v. Commissioner*, 55 T.C.M. (CCH) 1166 (1988); *Hill v. Commissioner*, 55 T.C.M. (CCH) 788 (1988). We do not pass on the correctness of these decisions.

in or appended to the notice should be considered. *Estate of Scofield v. Commissioner*, 266 F.2d 154, 167 (6th Cir. 1959) (Notice incorrectly stated period but adjustments and computations contained in notice based upon correct period; held notice covered correct year in substance and valid.); *Commissioner v. Forest Glen Creamery Co., supra*, at 971 (Notice incorrectly indicated tax year 1926 and period ending June 30, 1927; details in attached statement indicated that deficiency determination was for calendar year 1927).

The tax court incorrectly confined its inquiry to the date listed on the notice of deficiency and attached computations. The statutory notice states several times that the tax deficiency is due to the "reclassification of your Business Activity from a Trader to an Investor in securities." The statement of income tax changes indicates that the notice of deficiency is for individual income tax form 1040, not fiduciary income tax form 1041. On the investment interest expense deduction form, under the heading "Kind of Return," the box marked "individual" is checked. Thus, the estate clearly knew that the deficiency was calculated for an individual, Yaeger, and not his estate. The estate should have understood that the deficiency related to Yaeger's 1981 tax year, which ended May 11, 1981.[10]

In addition, every adjustment in the attachments to the notice of deficiency related to items reported on form 1040 for tax year ending May 11, 1981. In the statutory notice statement, the figures for the self-employment tax, the foreign tax credit, and the alternative minimum tax correspond to Yaeger's form 1040 filed for 1981. The figures in the statement of income tax changes and on the alternative minimum tax computation form are also

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[10] The estate argues that the commissioner could have determined that the estate's election to adopt April 30 as its fiscal year was not valid. Thus, when the estate received the notice it might have thought it was being assessed for the period May 11, 1981 to December 31, 1981.

This is not persuasive for two reasons: the notice and its attachments clearly referred to an individual, not an estate; and as a new taxpayer the estate was entitled to chose either a fiscal or calendar year as its tax year. *See* Title 26, Part 1, section 441-1T(b)(2) (1988).

tied to Yaeger's income tax return for the short period. Indeed, the alternative minimum tax computation form specifies that the figures are taken from certain lines of form 1040.

In fact, the estate can only point to one misleading figure, $3,907,422, which is shown on the investment interest expense deduction form as the interest expense on investment debt incurred after September 10, 1975. According to the estate, this figure is misleading because it far exceeds the interest expenses reported on schedule C for form 1040 but is close to, although not identical with, the amount of interest shown on schedule C for the estate's 1041 return. It is true that this figure does not appear on Yaeger's 1040 for the short period. However, it is not clear how this one error, if error it was, confused the estate.

The adjustments to Yaeger's income were clearly due to his classification as an investor rather than a trader. His interest expense deduction was thus recalculated. Of necessity, the corrected interest deduction form would contain new figures based on the recalculations. These new figures would include a revised carryover amount from 1979 and 1980, since the deduction for those years was also recalculated. A reasonable taxpayer would not rely solely on one figure in this corrected form to determine which year was being assessed.

In addition, a reasonable taxpayer would examine the statement of income tax changes and the computation of the investment income before searching through an unrelated tax form (the estate's 1041) to find one figure. The computation used figures from Yaeger's 1040 and clearly illustrated how the investment income was determined. Line 13 of the interest deduction form reported the allowable deduction as $1,759,567. The statement of income tax changes reported an interest expense carryover of $1,270,194. The need for any carryover at all only makes sense if, as every other objective factor would lead one to believe, the commissioner used the interest expense of $489,373 from Yaeger's 1040 for tax year ending May 11, 1981. The notice of deficiency and its attachments clearly and fairly advised the estate that the commissioner intended to assess it for the short period reported in Yaeger's 1981 return.

CONCLUSION

The order of the tax court dated February 2, 1989 deciding that there is a deficiency due from the taxpayer for taxable years 1979 and 1980 is affirmed. The order dated January 7, 1986 that dismissed so much of the petition that referred to tax year ending 1981 for lack of jurisdiction is reversed and the case is remanded for a trial on the issue of Yaeger's tax liability for the portion of the 1981 tax year ending May 11, 1981.

APPENDIX B

UNITED STATES TAX COURT

Docket No. 20514-83

T.C. Memo. 1988-264

ESTATE OF LOUIS YAEGER, DECEASED, JUDITH WINTERS, RAPHAEL MEISELS, ABRAHAM K. WEBER, AND THE BANK OF NEW YORK, EXECUTORS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Filed June 21, 1988

MEMORANDUM FINDINGS OF FACT AND OPINION

WRIGHT, *Judge*: By a notice of deficiency dated April 15, 1983, respondent determined deficiencies in Louis and Betty Yaeger's Federal income tax for the taxable years 1979 and 1980 in the amounts of $936,755 and $611,796, respectively.[1]

[1] In a notice of deficiency dated April 15, 1983, respondent also determined a deficiency in petitioners' 1981 Federal income tax in the amount of $451,669.25. With respect to taxable year 1981 only, respondent determined an addition to tax under section 6651(a) in the amount of $67,749. On November 12, 1985, petitioners moved to dismiss for lack of jurisdiction with respect to taxable year 1981 on the ground that respondent had failed to issue a notice of deficiency with respect to the proper taxable yar. We granted this motion and respondent appealed our decision to the United States Court of Appeals for the Second Circuit. (Appeal from our order was dismissed by the court of appeals. 801 F.2d 96 (2d Cir. 1986)).

After concessions,[2] the sole issue for our consideration is whether Yaeger was engaged in a trade or business with respect to his stock market trading activity and, if so, whether he is entitled to deduct interest paid with respect to the stock market trading activity, regardless of the limitation on the deductibility of investment interest in section 163(d).[3]

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and the attached exhibits are incorporated herein by this reference.

Louis Yaeger, the decedent (Yaeger or the decedent), and Betty Yaeger, his wife, resided in New York, New York. The Yaegers filed joint returns for taxable years 1979 and 1980 with the Internal Revenue Service Center in Holtsville, New York.

Yaeger died on May 11, 1981. On April 19, 1982, Judith Winters, Raphael Meisels (Meisels), Abraham K. Weber (Weber) and the Bank of New York were duly appointed executors (hereinafter collectively referred to as petitioners or as the executors) of Yaeger's will by the Surrogate's Court of the State of New York in the County of New York.

The executors, representing the estate of the decedent, filed a petition in this Court on July 15, 1983. At the time of filing all of the executors resided in New York, New York. Betty Yaeger filed a separate petition on July 18, 1983. On November 20, 1985, Betty Yaeger agreed to be bound by the outcome of the case brought by the executors of her husband's estate and is not a party in the instant proceeding.

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[2] Respondent conceded that petitioners were entitled to a net operating loss carry forward to taxable year 1979 only.

[3] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

Yaeger's life story unfolded through the testimony of his lifelong friend, Meisels[4] and by Yaeger's daughter and son-in-law, Judith[5] and Harold Winters. All three were knowledgeable and experienced with respect to stock market trading activities.

Yaeger graduated Phi Beta Kappa from Columbia University in 1921 having studied business and finance. Upon graduation he went to work as an accountant and subsequently became employed as an auditing agent for the Internal Revenue Service (the Service). He left the Service's employ in 1923 and went to work as a bond salesman in New York City, eventually becoming an investment counselor. As an investment counselor, Yaeger often solicited new customers by giving free advice until they developed confidence in his abilities.

Commencing in the mid-1920's, Yaeger began actively trading[6] stocks and bonds on the stock market on his own account in addition to conducting his investment consulting business. In the 1940's, Yaeger gave up his investment consulting business because the management of his own account had grown so demanding. Thereafter, he devoted himself exclusively to trading on his own account, which was his sole occupation until the day he died.

Prior to 1979, Yaeger maintained accounts with several brokerage firms in New York, including H. Hentz & Co., Pennington Colket & Co., F.T. Keech & Co., E.F. Hutton and Sterling

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[4] Meisels had known Yaeger since they began working together for the Internal Revenue Service in the 1920s. Meisels continued working as an agent for approximately forty years all the while amassing considerable wealth through stock market trading on his own account. He is currently honorary chairman Emeritus of Shearson Lehman Bros., Inc.

[5] Judith Winters is a financial analyst in her own right having studied finance and business at her father's urging. She described her own investment strategy as more passive and less bold than her father's.

[6] In describing Yaeger's activities with respect to his securities holdings, we use such words as "speculate," "trade," "invest" and similar terms purely for convenience and without intending any inference as to the tax characterization or consequences of any aspect of the transaction.

Grace. His account at H. Hentz & Co. was the largest account that firm had maintained for an individual United States citizen. During the period between 1979 and his death, Yaeger maintained accounts with Balfour Securities, Inc.,[7] Coleman & Co.,[8] and Laidlaw Adams & Peck, Inc. On occasion Yaeger also dealt with Cohn, Delaire & Kaufman, Inc.[9] and Mabon, Nugent & Co.

Trading activity in Yaeger's various accounts throughout the years in issue, is described in the following chart:

Year	*Purchase Transactions*	*Sales Transactions*	*Number Shares Bought*	*Number Shares Sold*
1979	1,176	86	1,453,555	822,955
1980	1,088	39	1,658,841	173,165

Yaeger maintained an office at H. Hentz & Co. (Hentz) from which he conducted most of his trading activity, although for a period of time he also maintained an office at Pennington, Colket & Co. After his retirement, Meisels joined Hentz as a partner and had an office near Yaeger's office. Hentz provided Yaeger with an assistant, a telephone, use of the secretarial pool, and access to the research staff and facilities. The assistant answered the phone, placed orders and assisted Yaeger's research efforts. Yaeger spent a full day at his office, researching investment opportunities and placing orders, and then returned home to read more financial reports late into the night. He worked every day of the week. When he was out of town, he maintained telephone contact with the brokers who handled his accounts.

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[7] Transactions handled for Yaeger's account by Balfour Securities Corp. were cleared through A.G. Becker, Inc. and Merrill Lynch Pierce Fenner & Smith.

[8] Transactions which were handled for Yaeger's account by Coleman & Co. were cleared through L.F. Rothschild, Unterberg, Towbin.

[9] Transactions handled for Yaeger's account by Cohn, Delaire & Kaufman, Inc. were cleared through Lehman Bros.

Yaeger was trading on the stock market the day before he died. Judith Winters indicated that her father's tremendous industry stemmed from his profound enjoyment of the subject matter he studied.

In his stock market activities, Yaeger subscribed to a distinct investment strategy. Yaeger's trading strategy was to buy the stock of companies in which the stock prices were extremely undervalued and hold the stock until the price returned to a level which reflected the underlying value of the company. He rarely purchased "blue chip" stocks and many of the stocks he held did not pay dividends. Instead, Yeager constantly looked for companies which were experiencing financial distress but whose underlying value was not widely recognized.

This strategy required extensive and thorough research. Because he was only interested in companies whose fortunes were temporarily unfavorable, his research extended beyond the study of mainstream publications. Yaeger read several journals and newspapers every day, including The Wall Street Journal, Forbes, Fortune, Financier and Barron's. He also pored over annual reports published by the companies whose stock he was considering purchasing. He studied reports from brokerage houses, Standard & Poors and Moody's. Yaeger searched the listing of stocks whose prices had recently hit new low levels. He also searched for companies which had recently failed to pay dividends. He looked for companies which had lately filed bankruptcy, particularly companies which held valuable but underutilized assets. For his research purposes, Yaeger required highly detailed information. Before purchasing stock he often wanted to know who had owned the stock he was interested in. If he needed particular information he occasionally telephoned the officers and managers of the company about which he was curious.

Once Yaeger determined that the targeted company was experiencing temporary difficulties, he began to accumulate the stock. Yaeger would buy stock as it became available, although some of the companies in which he was trying to invest were not frequently or actively traded and the stock was difficult to acquire. In the initial stages of his acquisition, he bought stock

in small quantities to avoid attracting the attention of other investors. When he attained a sizab'e amount of stock he would let his position become known.[10]

Yaeger took whatever steps he thought necessary to improve the position of the companies in which he invested, often supplying unsolicited business advice to the managers. Sometimes that advice was well received and the companies followed it. Occasionally, in order to strengthen the companies in which he held stock, Yaeger attemped to arrange mergers or acquisitions.[11] If management was intractable and Yaeger believed that their policies would inhibit the company's growth, he would sell his stock in the company.

Yaeger's investment strategy produced some startling successes.[12] For example, in 1980 Yaeger investigated a company called Seton Co., which was suffering considerable financial hardship. Seton Co. manufactured a material for covering automobile seats and sales had declined due to a slump in the automobile industry. Through reading a footnote in the annual report, Yaeger discovered that a division of Seton Company had discovered and manufactured a material which could be used as artificial skin. On the basis of the prospects for that division alone, Yaeger invested in Seton Co. Years later, the value of Seton

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[10] Once his position had been established Yaeger would encourage other investors to join him in buying stock but frequently he failed to attract much of a following. His investments were considered by many to be too speculative. His investments rarely coincided with conventional Wall Street wisdom.

[11] Judith Winters noted that this type of advice was usually disregarded because it might require that current management relinquish control of the company. Protecting the feelings of the current management was not one of Yaeger's priorities.

[12] One of Yaeger's investments was so speculative that he died without finding out if his prediction had been correct. For some time prior to his death Yaeger had been buying Cuban bonds which were issued by the Cuban government before the revolution which brought Castro to power. Yaeger decided that Castro would eventually be unseated and that the subsequent government might honor the debt of the pre-Castro regime. Yaeger was able to purchase the bonds at an extremely low price relative to the face value but died before learning if he would recoup his investment.

Co. rose dramatically as the company shifted to manufacturing artificial skin. Similarly, Yaeger purchased bonds issued by the New York, New Haven and Hartford Railroad between 1970 and 1979 while the company was in bankruptcy. Yaeger purchased some of the bonds for as little as $8 per $100 of face value. In 1979, after the company had been reorganized as Penn Central Corporation, Yaeger sold the bonds for about $80 apiece.

In addition to selecting financially troubled companies in which to invest, Yaeger increased his gain on his investments by using margin debt. Yaeger financed his purchases by borrowing to the maximum extent allowable under law and the custom of the brokerage houses, which was generally 50 percent. If the value of his stock rose he would use that increased value as equity to support more debt. From time to time Yaeger shifted accounts from one brokerage house to another in order to maximize the volume of margin debt he could carry. During the years 1979 and 1980, the ratio of Yaeger's margin debt to portfolio value was 47 percent and 42 percent, respectively. Yaeger's total stock market related debt equalled $42,154,048 in 1979 and $54,968,371 in 1980. When he died, his portfolio was subject to debt in the amount of $70,490,018.

Yaeger's maximum use of margin debt occasionally created problems for him, because if the value of his holdings in a particular account fell below the amount which the brokerage firm required to support the debt that the account was carrying, he was forced to sell enough stock to cover the debt even if it resulted in a loss. Once or twice during the course of his investment career Yaeger was almost "wiped out"[13]

Yaeger dedicated as much thought and careful planning to the decision of when to sell stock as he did to the decision of

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[13] The testimony was unclear on the details of Yaeger's periods of financial distress but Leo Boruchoff, Yaeger's broker at Coleman & Co., indicated that there had been a forced sale of Yaeger's stock in order to pay margin debt in both 1965 and 1974. He surmised that this situatiotn probably occurred at other times as well.

what stock to buy. He tried to hold stocks until they had increased in price to a level which he determined accurately reflected the company's true worth. Because he waited until there was a high enough price and corresponding demand, he was usually able to sell his entire block of stock quickly.

In 1979 and 1980 Yaeger reported income in the following amounts on his Federal income tax return:

1979	*Character of Income*	*Amount*
	Long-Term Capital Gain	$13,839,658
	Short-Term Capital Gain	184,354
	Dividends[14]	2,339,080
	Interest	57,958
	TOTAL	$16,421,050

1980	*Character of Income*	*Amount*
	Long-Term Capital Gain	$1,099,921
	Short-Term Capital Gain	728,404
	Dividends[14]	3,648,441
	Interest	91,717
	Director's fees	10,600
	TOTAL	$5,579,083

Of the stock which Yaeger sold in taxable years 1979 and 1980, the percentage of total sales of securities which he had held for 12 months or more was 88 percent and 91 percent, respectively. The purchase dates of the securities sold in 1980 ranged from March 1970 to December 1979. In 1979 Yaeger did not sell any security which had been held for less than three months and

[14] These figures were taken from Yaeger's income tax returns for the years 1979 and 1980. In exhibits and briefs the parties used the figures $2,281,122 and $3,556,724 for dividend income in 1979 and 1980, respectively. Since there was no explanation provided for the discrepancy, we have chosen to rely on the figures put forth in the tax returns.

in 1980, each security sold had been held for at least six months. On Schedule C of the joint returns, Yaeger deducted interest expense in 1979 and 1980 in the amounts of $5,865,833 and $7,995,010, respectively.

OPINION

The sole issue for our consideration is whether Yaeger was subject to the limitation on investment interest imposed by section 163(d). Section 163(d) restricts the amount of the deduction which can be claimed for interest which is paid or accrued with respect to investment property.[15] On the other hand, interest paid or accrued on indebtedness which is incurred to acquire or carry property for the taxpayer's trade or business is fully deductible. Sec. 163(a).

The House Report pertaining to section 163(d) explains that the primary concern underlying the section was the possibility that a deduction for investment interest could offset other unrelated income. Furthermore, the report continued:

> Where the taxpayer's investment * * * produces little current income, the effect of allowing a current deduction for the interest is to produce a mismatching of

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[15] Section 163(d) provided in pertinent part:

(1) In General.—In the case of a taxpayer other than a corporation, the amount of investment interest (as defined in section (3)(D)) otherwise allowable as a deduction under this chapter shall be limited, in the following order, to —

(A) $10,000 * * *, plus

(B) the amount of the net investment income * * *, plus the amount (if any) by which the deductions allowable under this section * * * and sections 162, 164(a)(1) or (2), or 212 attributable to property of the taxpayer subject to a net lease exceeds the rental income produced by such property for the taxable year.

* * * * * * *

[(3)](D) Investment Interest.—

(i) In General.—The term "investment interest" means interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment.

> the investment income and related expenses of earning that income. In addition, the excess interest, in effect, is used by the taxpayer to offset other income, such as his salary, from taxation.

H. Rept. 91-413 (Part I) (1969), 1969-3 C.B. 200, 245.

Historically, we have recognized three distinct categories of securities ownership, the most clear cut of which is the securities dealer. Dealers regularly buy and sell to customers and provide such other services as required to manage the securities holdings of their clients. Dealers fall clearly into the category of persons who are in the trade or business of buying, owning and selling securities. *Kemon v. Commissioner*, 16 T.C. 1026, 1032-1033 (1951). On the other end of the spectrum, a passive investor who holds stock for its dividend yield and for the ultimate profit from resale is not considered to be engaged in a trade or business with respect to his stock ownership activities. *Higgins v. Commissioner*, 312 U.S. 212 (1941); *City Bank Farmers Trust Co. v. Helvering*, 313 U.S. 121 (1941); *United States v. Pyne*, 313 U.S. 127 (1941); *Gajewski v. Commissioner*, 723 F.2d 1062 (2d Cir. 1983), cert. denied 469 U.S. 818 (1984); *Moller v. United States*, 721 F.2d 810 (Fed. Cir. 1983). Between the securities dealers and the passive investors lies the securities trader. Unlike a securities dealer, a trader has no customers and trades only on his own account. However, the trading activity in which traders engage resembles the activity of a dealer in every other respect. *Kemon v. Commissioner, supra.*

Respondent initially contends that the section 163(d) limitation on the deduction for investment interest applies to all interest paid or accrued with respect to any investment in securities. With an exception for securities dealers who sell to customers, respondent maintains that there can be no distinction between trading securities as an investment and trading securities as a trade or business.[16] However, respondent's position

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[16] Respondent's concern, quite understandably, is that the dealer (sic) is entitled to all the tax advantages reserved for businesses and yet reports his gain and losses from his business as capital gain or loss. As we discussed in *King v. Commissioner*, 89 T.C. 445, 457-458 (1987), citing to *Wood v. Commissioner*, 16 T.C. 213 (1951), this arrangement was intended by Congress.

is one which we and other courts have consistently declined to adopt. *Snyder v. Commissioner*, 295 U.S. 134 (1935); *Levin v. United States*, 597 F.2d 760 (Ct. Cl. 1979). As we recently held in *King v. Commissioner*, 89 T.C. 445 (1987), the debt which a trader incurs in order to carry on the trade or business of trading is not subject to section 163(d).[17]

Whether a taxpayer's trading activities rise to a level which constitutes a trade or business is a question of fact and circumstances. *Higgins v. Commissioner, supra*; *Liang v. Commissioner*, 23 T.C. 1040, 1045 (1955). In *Commissioner v. Groetzinger*, 480 U.S. __ (1987), the Supreme Court reviewed the definition of the phrase "trade or business" as it evolved through the decades of case law.[18] In determining that the taxpayer's gambling activities constituted a trade or business, the Court abandoned the historical requirement that a person in a trade or business must provide goods and services to the public. Rather, the Court decided that "to be engaged in a trade or business, the taxpayer must be involved in the activitiy with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit." 107 S.Ct. at 987.

The question of when the trading activity of a taxpayer passes over the line between investment activity and trade or business activity has been frequently litigated. From the many cases, various factors have developed for purposes of distinguishing the different types and degrees of activities.

In order to be engaged in the trade or business of trading securities, the taxpayer must be actively involved in the trading activities. *Liang v. Commissioner, supra* at 1045. The activity must absorb a major portion of the taxpayer's time and efforts

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[17] This conclusion was supported by the legislative history for section 163(d) which provided that "interest on funds borrowed in connection with a trade or business would not be affected by the limitation." H. Rept. 91-413 (Part I) (1969), 1969-3 C.B. 200, 246.

[18] See generally: Boyle, "What is a Trade or Business?," 39 Tax Lawyer 737 (Summer 1986).

and be conducted for the purpose of making a livelihood. *Snyder v. Commissioner, supra* at 139. A trade or business requires more than keeping records, collecting income from interest and dividends, and exercising managerial supervision over the securities accounts. *Higgins v. Commissioner, supra* at 218. Ordinarily, neither a trust nor an estate can be a trade or business. *City Bank Farmers Trust Co. v. Helvering, supra; United States v. Pyne, supra.*

A trader derives his profit primarily from frequent exchanges which take advantage of short-term swings in the market rather than from interest, dividends and long-term appreciation. *King v. Commissioner, supra* at 458; *Liang v. Commissioner, supra* at 1043; *Moller v. United States, supra* at 815. Thus, an emphasis on capital growth and an expectation of profit from resale alone, coupled with dim prospects for current net income, indicate an investment motivated activity rather than a trade or business. *Miller v. Commissioner*, 70 T.C. 448, 457 (1978).

Petitioners maintain that Yaeger's stock market activities constituted a trade or business and, therefore, that the interest accrued with respect to those activities cannot be subject to the limitations imposed by section 163(d). Petitioners bear the burden of proving that Yaeger's stock market activities were a trade or business. *Welch v. Helvering*, 290 U.S. 111, 115 (1933); Rule 142(a).

Petitioners urge us to conclude that Yaeger was a trader on the grounds of his active involvement with the management of his stock and bond holdings. They point to the dedication and zeal with which he studied the market, the extensive research he conducted, the strategic buying and selling of stock, and the generally professional attitude he displayed toward his stock market activities. Petitioners argue that because the highly leveraged positions Yaeger took would be too speculative for the average investor, we are constrained to conclude that he was a trader.

Petitioners rely heavily on *Levin v. United States, supra*, in which the United State Court of Claims decided, among other issues, that the taxpayer's stock market activities were a trade or

business. Like Yaeger, Levin devoted all his time and attention to the buying and selling of stocks for his own account although Yaeger's stock market trading equalled or exceeded Levin's in quantity. Levin frequently visited the companies in which he held stock to give suggestions and advice to management just as Yaeger did. Levin also actively studied the market and associated with other investors although Yaeger's research was more extensive and the positions he eventually held were more risky. Levin, like Yaeger, purchased to the maximum extent of available margin debt. Petitioners therefore urge us to find that Yaeger was a trader because he conducted his stock market activities with even greater zeal and thoroughness than Levin did.

Levin's extensive personal involvement with his stock market trading, coupled with the volume of transactions which transpired, led the Court of Claims to determine that he was in the trade or business of trading on the stock market. *Levin v. United States*, *supra* at 765. In reaching this conclusion the court wrote "a 'trader' is an active investor in that he does not passively accumulate earnings, nor merely oversee his accounts, but manipulates his holdings in an attempt to produce the best possible yield." *Levin v. United States*, *supra* at 765.

Respondent counters that Yaeger was never more than an investor with respect to his stock market activities. Citing to *Moller v. United States*, *supra* at 814, respondent maintains that the considerable time and energy Yaeger spent managing his investments is not in itself sufficient to bring his trading activities to the level of trade or business.

Respondent further asserts that the two fundamental criteria for distinguishing between traders and investors established in *Liang v. Commissioner*, *supra*, control the result here. In *Liang*, we found that the length of the holding period is a determining factor, while the second factor is whether the activity produces current income from dividends and interest. 23 T.C. at 1045. Respondent argues that because Yaeger's stock was held with an eye toward long-term appreciation in value, and because Yaeger had received dividends and interest in taxable years 1979

and 1980 in the amounts of $2,397,038 and $3,740,158, respectively, Yaeger's activity satisfied both parts of the test put forward in *Liang v. Commissioner, supra.*

After carefully reviewing all the facts and circumstances as established by the testimony and exhibits, we conclude that Yaeger was not a securities trader within the meaning of section 163(d), because he held his stocks and bonds for lengthy periods of time anticipating that they would appreciate in value.

There is no doubt that Yaeger devoted greater time, energy, enthusiasm and dedication to his stock market activities than many people devote to their full time employment. His investment strategy was unique and he maintained a margin of debt which would have caused a more faint-hearted investor to quail. His activity with respect to the management of his holdings was continuous, regular and conducted for profit. Despite the impressive nature and extent of Yaeger's stock market trading activities, however, this is not the sole determination of the issue. The pivotal inquiry is whether Yaeger was interested in deriving income from capital appreciation or from short-term trading. In resolving this issue we cannot summarily dismiss those cases which indicate that the length of the holding period is a crucial factor in determining whether a taxpayer's trading activities rise to the level of a trade or business. See, e.g., *Miller v. Commissioner, supra*; *Moller v. Commissioner, supra*. As we recently noted in *King v. Commissioner, supra* at 461, "the primary characteristic which differentiates the activities of a trader from those of an investor is that a trader seeks short-swing gains while an investor seeks long-term appreciation."

While we have never articulated the specific duration of holding period which divides short-swing gain from long-term appreciation, clearly Yaeger's holding periods of several years were not short-swing. Yaeger's purchases often preceded his sales by months, if not years. For example, he spent nine years accumulating the stock he held in the New York, New Haven and Hartford Railroad. The Cuban bonds had not been sold by the time he died. There is no evidence which would suggest that

Yaeger intended to derive profit from relatively short-term turnovers. Rather, the bulk of Yaeger's investments were oriented toward long-term appreciation due, in large part, because they had so little value when he bought them. Accordingly, we are unable to find any distinguishable difference between the lengthy periods for which Yaeger held his securities and the holding periods which create investor status for purposes of section 163(d).

Yaeger's stock market activities were fundamentally the same as the activity of other investors. He targeted a stock which was, for some reason, selling at a price below what it was worth. He bought the stock at this low price and waited for the fortunes of the company to improve, finally selling the stock for a profit. This activity is defined as investment. The distinguishing characteristic with respect to Yaeger's activity is that he took unusually risky positions, based on his extensive research, and that he produced some startling successes. This, however, only makes him a very good investor, rather than a trader.

Although *Levin v. United States, supra*, is factually similar in many respects, the opinion did not discuss the frequency of the taxpayer's trades or whether they were short-term transactions or investments held for capital appreciation. However, the record shows that Yaeger held his stocks and bonds a lengthy period hoping for capital appreciation and in consideration of the length of holding period criterion which we have historically employed to assist us in determining whether a taxpayer who manages his own investments is an investor or a trader, we have concluded that Yaeger was an investor.[19]

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[19] On April 27, 1987, respondent made a motion to strike certain appendices which had been attached to petitioner's reply brief. These appendices were documents which had been submitted into evidence and included into the record of the Court of Claims case. *Levin v. United States*, 597 F.2d 760 (Ct.Cl. 1979). Because these documents were not properly introduced into the recrod in the case before us we can only consider them as evidence if we take judicial notice of them. Rule 143(b). However, rule 201(b), Fed. R. Evid., limits the material over which we may take judicial notice to that which is either (1) generally known within the territorial jurisdiction of the trial court, or (2)

(*Footnote continued*)

In light of the reasons put forward above, we hold that Yaeger was not a trader but rather was an investor within the meaning of section 163(d). Therefore, the deductions for interest which Yaeger claimed for taxable years 1979 and 1980 are subject to the limitation on investment interest of section 163(d).

To reflect the foregoing,

Decision will be entered under Rule 155.

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capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned. Although we generally take judicial notice of the existence of opinions from other courts we rarely include judicial notice of the findings of fact set forth in those opinions. *Estate of Reis* v. *Commissioner*, 87 T.C. 1016, 1028 (1986). Therefore we decline to consider the appendices in question as evidence before us.

APPENDIX C

UNITED STATES TAX COURT

Docket No. 20514-83

ESTATE OF LOUIS YAEGER, DECEASED, JUDITH WINTERS, RAPHAEL MEISELS, ABRAHAM K. WEBER, AND THE BANK OF NEW YORK, EXECUTORS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ORDER

This case was called from the calendar for the trial session at New York, New York on November 12, 1985. At that time, counsel for petitioner filed with the Court a motion to dismiss for lack of jurisdiction as to the taxable year 1981. Petitioner's motion alleges that the statutory notice of deficiency issued by respondent for calendar year 1981 is invalid in that it sets forth an incorrect taxable year.

This Court's jurisdiction depends upon the issuance by the Commissioner of a notice of deficiency. I.R.C. §6214(a); Rule 13(a), Tax Court Rules of Practice and Procedure. The notice of deficiency must set forth the taxable year involved. *Scar v. Commissioner*, 81 T.C. 855, 860-61 (1982(sic)). This Court has no jurisdiction to redetermine a deficiency for any year not set forth in the notice of deficiency. I.R.C. §6214(b).

In the instant case, the notice of deficiency and supporting documents which were mailed to the taxpayer by the Commissioner reflected computations based on calendar year 1981. However, petitioner did not file a return for calendar year 1981.

Petitioner instead filed returns for the following periods: January 1, 1981 through May 11, 1981 and May 11, 1981 through April 30, 1982. The first return filed by petitioner was an income tax return in the name of "Louis Yaeger (Deceased) May 11, 1981". Petitioner filed a second return on behalf of the Estate of Louis Yaeger for the fiscal year ended April 30, 1982. Respondent has not objected to the termination of petitioner's initial taxable year on the date of death of petitioner's decedent nor to the adoption of a fiscal year by the estate. No notice of deficiency was issued by respondent to petitioner for either the tax year ended May 11, 1981 or the taxable year ended April 30, 1982.

In *Century Data Systems, Inc. v. Commissioner*, this Court stated:

> "[W]here the statutory notice describes an incorrect taxable year composed of some portion of each of two correct taxable years, the notice is inherently erroneous because the deficiency asserted has necessarily omitted items of income and deduction of the correct taxable year and has included other items which properly belong in another taxable year."

80 T.C. 529, 534-535 (1983). However, if the notice of deficiency contains an error relating to the taxable year involved, the error will be ignored if the taxpayer was not misled by an inconsistency between the first page and the appended computations in the statement which together made up the deficiency notice. *Estate of Stranahan v. Commissioner*, T.C. Memo. 1971-250. In the instant case, both the first page and the appended computations showed the date of December 31, 1981. Thus, petitioner was unable to determine from either the first page or the appended computations which taxable year was referred to in the notice of deficiency.

Respondent relies on *Sanderling, Inc. v. Commissioner*, 66 T.C. 743 (1976), affd. 571 F.2d 174 (3d Cir. 1978). The petitioner in *Sanderling* was a corporation which liquidated prior to the end of the fiscal year for which the notice of deficiency

was issued. Thus, petitioner's taxable year ended on the liquidation date, rather than on the date specified in the notice of deficiency. Although the notice of deficiency covered a period longer than the taxable year of the petitioner, the petitioner was no longer in existence following liquidation, and the transaction at issue occurred prior to the end of the taxpayer's taxable year. This Court held on those facts that where the notice of deficiency covered a period of time longer than that asserted by the taxpayer to be the proper period, the notice of deficiency was valid and this Court had jurisdiction to redetermine the amount of the deficiency involved.

The notice of deficiency at issue herein covers one full taxable year and a portion of a second taxable year. It does not indicate whether the deductions and expenses disallowed by respondent were incurred in the period from January 1 through May 11, 1981 or in the period from May 11, 1981 through April 30, 1982. Although respondent argues that this Court should take jurisdiction over the short taxable year from January 1 through May 11, 1981, there is no indication in the statutory notice of deficiency that the adjustments made by respondent related to items incurred prior to May 11, 1981. Therefore, the statutory notice issued by respondent is invalid.

After due consideration and based on the foregoing, it is hereby

ORDERED that petitioner's motion to dismiss for lack of jurisdiction is granted.

/s/ Lawrence A. Wright

Judge

Dated: Washington, D.C.
January 7, 1986

APPENDIX D

The Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the years 1979 through 1981, provided in pertinent part:

§163. Interest.

(a) General Rule. — There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

. . .

(d) Limitation on Interest on Investment Indebtedness. —

(1) In general. — In the case of a taxpayer other than a corporation, the amount of investment interest (as defined in paragraph (3)(D)) otherwise allowable as a deduction under this chapter shall be limited, in the following order, to -

(A) $10,000 ($5,000, in the case of a separate return by a married individual), plus

(B) the amount of the net investment income (as defined in paragraph (3)(A)), plus the amount (if any) by which the deductions allowable under this section (determined without regard to this subsection) and sections 162, 164(a)(1) or (2), or 212 attributable to property of the taxpayer subject to a net lease exceeds the rental income produced by such property for the taxable year.

In the case of a trust, the $10,000 amount specified in subparagraph (A) shall be zero.

(2) Carryover of disallowed investment interest. — The amount of disallowed investment interest for any taxable year shall be treated as investment interest paid or accrued in the succeeding taxable year.

(3) Definitions. — For purposes of this subsection -

(A) Net investment income. — The term "net investment income" means the excess of investment income over investment expenses. . . .

(B) **Investment income.** — The term "investment income" means -

(i) the gross income from interest, dividends, rents, and royalties,

(ii) the net short-term capital gain attributable to the disposition of property held for investment, and

(iii) any amount treated under sections 1245, 1250, and 1254 as ordinary income,

but only to the extent such income, gain, and amounts are not derived from the conduct of a trade or business.

(C) **Investment expenses.** — The term "investment expenses" means the deductions allowable under sections 162, 164(a)(1) or (2), 166, 167, 171, 212, or 611 directly connected with the production of investment income. . . .

(D) **Investment interest.** — The term "investment interest" means interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment.

(E) **Disallowed investment interest.** — The term "disallowed investment interest" means with respect to any taxable year, the amount not allowable as a deduction solely by reason of the limitation in paragraph (1).

(4) **Special rules.** —

(A) **Property subject to net lease.** — For purposes of this subsection, property subject to a lease shall be treated as property held for investment, and not as property used in a trade or business, for a taxable year, if—

(i) for such taxable year the sum of the deductions of the lessor with respect to such property which are allowable solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) is less than 15 percent of the rental income produced by such property, or

(ii) the lessor is either guaranteed a specified return or is guaranteed in whole or in part against loss of income.

. . .

(D) **Construction interest.** — For purposes of this subsection, interest paid or accrued on indebtedness incurred or continued in the construction of property to be used in a trade or business shall not be treated as investment interest.

§6201. ASSESSMENT AUTHORITY.

(a) **Authority of Secretary.** — The Secretary is authorized and required to make the inquiries, determinations, and assessments of all taxes (including interest, additional amounts, additions to the tax, and assessable penalties) imposed by this title, . . . at the time and in the manner provided by law. Such authority shall extend to and include the following:

(1) **Taxes shown on return.** — The Secretary shall assess all taxes determined by the taxpayer or by the Secretary as to which returns or lists are made under this title.

§6203. METHOD OF ASSESSMENT.

The assessment shall be made by recording the liability of the taxpayer in the office of the Secretary in accordance with rules or regulations prescribed by the Secretary . . . .

§6212. NOTICE OF DEFICIENCY.

(a) **In General.** — If the Secretary determines that there is a deficiency in respect of any tax imposed by subtitle A . . ., he is authorized to send notice of such deficiency to the taxpayer by certified mail or registered mail.

(c) **Further Deficiency Letters Restricted.** —

(1) **General rule.** — If the Secretary has mailed to the taxpayer a notice of deficiency as provided in subsection (a), and the taxpayer files a petition with the Tax Court within the time prescribed in section 6213(a), the Secretary shall have no right to determine any additional deficiency of income tax for the same taxable year . . . to which such petition relates, except in the case of fraud, and except as provided in section 6214(a) (relating to assertion of greater deficiencies before the Tax Court), in section 6213(b)(1)(relating to mathematical or

clerical errors), in section 6851 (relating to termination assessments), or in section 6861(c) (relating to the making of jeopardy assessments).

§6213. RESTRICTIONS APPLICABLE TO DEFICIENCIES; PETITION TO TAX COURT.

(a) **Time for Filing Petition and Restriction on Assessment.** — Within 90 days . . . after the notice of deficiency authorized in section 6212 is mailed . . ., the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency. Except as otherwise provided in section 6851 or section 6861 no assessment of a deficiency in respect of any tax imposed by subtitle A . . . and no levy or proceeding in court for its collection shall be made, begun, or prosecuted until such notice has been mailed to the taxpayer, nor until the expiration of such 90-day . . . period . . ., nor, if a petition has been filed with the Tax Court, until the decision of the Tax Court has become final . . . .

§6214. DETERMINATIONS BY TAX COURT.

(a) **Jurisdiction as to Increase of Deficiency, Additional Amounts, or Additions to the Tax.** — . . . [T]he Tax Court shall have jurisdiction to redetermine the correct amount of the deficiency even if the amount so redetermined is greater than the amount of the deficiency, notice of which has been mailed to the taxpayer . . . .

(b) **Jurisdiction Over Other Years and Quarters.** — The Tax Court in redetermining a deficiency of income tax for any taxable year . . . shall consider such facts with relation to the taxes for other years . . . as may be necessary correctly to redetermine the amount of such deficiency, but in so doing shall have no jurisdiction to determine whether or not the tax for any other year . . . has been overpaid or underpaid.

§6303. NOTICE AND DEMAND FOR TAX.

(a) **General Rule.** — Where it is not otherwise provided by this title, the Secretary shall, as soon as practicable, and within 60

days, after the making of an assessment of tax pursuant to section 6203, give notice to each person liable for the unpaid tax, stating the amount and demanding payment thereof . . . .

§6501. LIMITATIONS ON ASSESSMENT AND COLLECTION.

(a) **General Rule.** — Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) . . ., and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.

§6503. SUSPENSION OF RUNNING OF PERIOD OF LIMITATION.

(a) **Issuance of Statutory Notice of Deficiency.** —

(1) **General rule.** — The running of the period of limitations provided in section 6501 or 6502 on the making of assessments or the collection by levy or a proceeding in court, in respect of any deficiency as defined in section 6211 . . ., shall (after the mailing of a notice under section 6212(a)) be suspended for the period during which the Secretary is prohibited from making the assessment or from collecting by levy or a proceeding in court (and in any event, if a proceeding in respect of the deficiency is placed on the docket of the Tax Court, until the decision of the Tax Court becomes final), and for 60 days thereafter.

§6512. LIMITATIONS IN CASE OF PETITION TO TAX COURT.

(b) **Overpayment Determined by Tax Court.**—

(1) **Jurisdiction to determine.** — Except as provided by paragraph (3) and by section 7463, if the Tax Court finds that there is no deficiency and further finds that the taxpayer has made an overpayment of income tax for the same taxable year. . . in respect of which the Secretary determined the deficiency, or finds that there is a deficiency but that the taxpayer has made an overpayment of such tax, the Tax Court shall have jurisdiction to determine the amount of such overpayment, and such amount shall, when the decision of the Tax Court has become final, be credited or refunded to the taxpayer.

No. 89-1253

(2)

FILED
APR 30 1990
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CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1989

ESTATE OF LOUIS YAEGER, DECEASED, BY JUDITH WINTERS, EXECUTOR, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

KENNETH W. STARR
Solicitor General

SHIRLEY D. PETERSON
Assistant Attorney General

RICHARD FARBER
MARY FRANCES CLARK
Attorneys
Department of Justice
Washington, D.C. 20530
(202) 633-2217

BEST AVAILABLE COPY

QUESTIONS PRESENTED

1. Whether the interest expenses incurred by decedent Louis Yaeger in purchasing securities on margin were subject to the limitations on the deductibility of "investment interest" imposed by Section 163(d) of the Internal Revenue Code.

2. Whether the notice of deficiency issued to the decedent's estate with respect to 1981, the taxable year in which he died, was invalid because the notice erroneously indicated that the taxable period involved was the entire calendar year 1981, rather than the period beginning January 1, 1981, and ending on May 11, 1981, the date of the decedent's death.

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In the Supreme Court of the United States

OCTOBER TERM, 1989

No. 89-1233

ESTATE OF LOUIS YAEGER, DECEASED, BY JUDITH WINTERS, EXECUTOR, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-15a) is reported at 889 F.2d 29. The opinion of the Tax Court with respect to the interest question (Pet. App. 16a-31a) is unofficially reported at 55 T.C.M. (CCH) 1101. The order of the Tax Court with respect to the notice of deficiency question (Pet. App. 32a-34a) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on November 7, 1989. The petition for a writ of certiorari was filed on February 1, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

A. 1. Beginning in the mid-1920's, decedent Louis Yaeger began actively trading [1] stocks and bonds on the stock market on his own account, in addition to conducting an investment consulting business. In the 1940's, Yaeger gave up his investment consulting business because the management of his own account had grown so demanding. Thereafter, he devoted himself exclusively to trading on his own account, which was his sole occupation until the day he died. Yaeger maintained accounts with several brokerage firms in New York, including one where he maintained an office. He typically spent a full day at his office, researching investment opportunities and placing orders, and then read more financial reports at home. Pet. App. 3a.

Yaeger subscribed to a distinct investment strategy. He sought to buy the securities of companies that were extremely undervalued and to hold the securities until they reached a price that reflected the underlying value of the company. Thus, he rarely purchased "blue chip" stocks, and many of the stocks he held did not pay dividends. Yaeger engaged in thorough research to look for companies that were experiencing financial distress but whose underlying value was not recognized. Once Yaeger reached the conclusion that a company was experiencing temporary difficulties, he began to accumulate its stock. He would initially buy small quantities of stock to avoid attracting attention from other investors until

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[1] Like the courts below (see Pet. App. 18a n.6; *id.* at 2a n.3), we will use such words as "speculate," "trade," and "invest," for convenience in describing Yaeger's activities, without intending any inference as to the tax characterization or consequences of those activities.

he had accumulated a significant number of shares. Yaeger would try to retain his holdings until they had increased in price to a level that he believed reflected the company's true worth, when he could quickly sell a large block of shares. Pet. App. 4a, 23a.

Yaeger's investment strategy of acquiring stocks in numerous small units until he possessed a substantial block, which he then would hold until the price appreciated to the desired level, is illustrated by the pattern of his transactions in the years at issue. In 1979, he had 1,176 purchase transactions and only 86 sales transactions. In 1980, he had 1,088 purchase transactions and only 39 sales transactions. Pet. App. 3a. The transactions in these years also reflect that Yaeger's strategy was designed to produce profit from capital appreciation (as well as dividends and interest) rather than from short-term swings in the market; in 1979, he reported long-term capital gain of $13,839,658, dividends of $2,339,080, and interest of $57,958, but reported short-term capital gain of only $184,354.[2] For 1980, his long-term capital gain, dividends, and interest totaled $4,840,079, while his short-term capital gain was only $728,404. Pet. App. 5a.

Yaeger financed his purchases by borrowing to the maximum extent allowable under law and the custom of the brokerage houses, which was generally 50%. If the value of his stock rose, he would use that increased value as equity to support more debt. Dur-

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[2] During these years, gain from the sale of stock held for more than one year was defined as long-term capital gain, and gain from the sales of stock held for one year or less was defined as short-term capital gain. See 26 U.S.C. 1222(1) and (3) (1982).

ing the years 1979 and 1980, Yaeger's margin debt was 47% and 42%, respectively, of his portfolio value. Yaeger's total stock market related debt equaled $42,154,048 in 1979 and $54,968,371 in 1980. His interest expense with respect to this debt was $5,865,833 in 1979 and $7,995,010 in 1980. Pet. App. 4a-6a.

2. On his tax returns for 1979 and 1980, Yaeger deducted the full amount of the interest expenses he had incurred in those years. On audit, the Commissioner determined that Yaeger's interest expenses constituted "investment interest" within the meaning of Section 163(d) of the Internal Revenue Code,[3] and therefore that those expenses were deductible only to the extent of his "investment income." [4] Since that

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[3] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the tax years at issue (the Code or I.R.C.).

[4] Section 163(d) of the Code provided, in pertinent part, as follows:

> (1) In general
>
> In the case of a taxpayer other than a corporation, the amount of investment interest (as defined in paragraph (3)(D)) otherwise allowable as a deduction under this chapter shall be limited, in the following order, to—
>
> (A) $10,000 * * *, plus
>
> (B) the amount of the net investment income * * *,
>
> * * * * *
>
> (3) Definitions
>
> For purposes of this subsection—
>
> * * * * *
>
> (B) Investment income
>
> The term "investment income" means—
>
> (i) the gross income from interest, dividends, rents, and royalties,

latter term, as defined in Section 163(d)(3)(B) of the Code, encompassed only Yaeger's dividends, interest, and short-term capital gain, but not his long-term capital gain, the Commissioner disallowed in substantial part the interest deductions claimed by Yaeger.

Petitioners contested in the Tax Court the deficiencies in tax resulting from the disallowance of a large portion of the interest expense deductions. Petitioners maintained that Yaeger's extensive stock market activities constituted a trade or business, that the interest expenses in issue represented ordinary and necessary expenses of that trade or business, and that such business expenses could not be considered as "investment interest" under Section 163(d). The Tax Court rejected these contentions and sustained the deficiencies. Pet. App. 24a-31a.

The court explained that the decisional law long has drawn a distinction between "investors" and "traders," who seek to profit not from long-term capital appreciation in their investments, but rather from frequent trading to take advantage of short-term price swings in the market. These cases have

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(ii) the net short-term capital gain attributable to the disposition of property held for investment, and

(iii) any amount treated under sections 1245, 1250, and 1254 as ordinary income,

but only to the extent such income, gain, and amounts are not derived from the conduct of a trade or business.

* * * * *

(D) Investment Interest

The term "investment interest" means interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment.

held that the activities of a trader can rise to the level of a trade or business, like those of a "dealer," but that those of an investor do not. Pet. App. 25a-27a. And the court further noted that "[t]he question of when the trading activity of a taxpayer passes over the line between investment activity and trade or business activity" is one that turns on the "facts and circumstances" (*id.* at 29a; see also *id.* at 26a) of each case. On these facts, the Tax Court concluded that Yaeger was an investor, not a person engaged in the trade or business of trading securities. Pointing to the undisputed evidence establishing that Yaeger's consistent practice was to purchase securities he considered to be greatly undervalued and to hold such securities for long-term appreciation, the court determined that Yaeger's stock market activities, although regular and extensive, were those of an investor. *Id.* at 29a-30a.[5]

3. The court of appeals affirmed on this issue (Pet. App. 7a-9a). Like the Tax Court, the court of appeals stated that the case law has long drawn a distinction between investors, who "are 'primarily in-

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[5] The court elaborated on this conclusion as follows (Pet. App. 30a):

> Yaeger's stock market activities were fundamentally the same as the activity of other investors. He targeted a stock which was, for some reason, selling at a price below what it was worth. He bought the stock at this low price and waited for the fortunes of the company to improve, finally selling the stock for a profit. This activity is defined as investment. The distinguishing characteristic with respect to Yaeger's activity is that he took unusually risky positions, based on his extensive research, and that he produced some startling successes. This, however, only makes him a very good investor, rather than a trader.

terested in the long-term growth potential of their stocks' " and who are not engaged in a trade or business, and traders, who trade securities "with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short term basis" and may be engaged in a trade or business. *Id.* at 7a-8a. Noting that most of Yaeger's profits came from long-term appreciation, interest, and dividends, the court of appeals stated that "[t]his emphasis on capital growth and profit from resale indicates an investment motivated activity" (*id.* at 9a). The court further concluded that the resulting disallowance of Yaeger's interest expenses in the instant case, to the extent those expenses exceeded his investment income, was fully in accord with the congressional purpose underlying the limitations embodied in Section 163(d) (Pet. App. 8a-9a).

B. 1. Yaeger died on May 11, 1981. Pursuant to Section 443(a) of the Code, his taxable year 1981 automatically terminated on the date of his death. His estate filed a federal income tax return (Form 1040) on his behalf for the short period January 1, 1981, through May 11, 1981.[6] After conducting examinations of Yaeger's returns for 1979, 1980, and 1981, the Commissioner issued two notices of deficiency concerning those years. One notice of deficiency determined deficiencies for the taxable years ending December 31, 1979, and December 31, 1980. The second notice of deficiency was issued for the taxable year 1981. The latter notice incorrectly indicated that the taxable period involved was the calen-

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[6] Yaeger's estate elected a fiscal year ending April 30 and later filed a fiduciary income tax return (Form 1041) covering the income tax owed by the estate for the period May 11, 1981, through April 30, 1982. Pet. App. 10a.

dar year ending December 31, 1981, rather than the short taxable period occasioned by Yaeger's death, which ran from January 1, 1981, through May 11, 1981. Petitioners filed a single petition in the Tax Court for redetermination of the deficiencies set forth in the two notices of deficiency. More than two years later, when the case was called for trial, petitioners moved to dismiss for lack of jurisdiction the portion of the petition relating to the taxable year 1981, claiming that the deficiency notice for that year was a nullity because of the error in describing the taxable period involved. Pet. App. 10a, 32a.[7]

2. The Tax Court granted the estate's motion to dismiss the petition with respect to the 1981 taxable year for lack of jurisdiction (Pet. App. 32a-34a). Noting that its jurisdiction is dependent upon the issuance of a valid notice of deficiency, the Tax Court ruled that it had no jurisdiction to consider an asserted deficiency for any year not set forth in the notice. Because the notice of deficiency issued by the Commissioner for Yaeger's taxable year 1981 indicated that it covered a period that included both the correct 1981 taxable year plus a portion of the next taxable period, the court held that the notice was invalid.

3. The court of appeals reversed on this issue (Pet. App. 10a-15a). The court held that mistakes in the contents of a notice of deficiency do not render the notice invalid where the mistakes do not frustrate the basic purpose of the notice, *viz.*, to inform the taxpayer that a deficiency in a specified amount has been determined in his tax for a particular pe-

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[7] At the time this motion was filed, the expiration of the statute of limitations precluded the Commissioner from issuing a new notice of deficiency that would correct the error in describing the taxable period.

riod (*id.* at 11a-12a). Here, the court concluded, the deficiency notice was sufficient to advise petitioners that the deficiency determined by the Commissioner related to the Form 1040 filed by petitioners on behalf of Yaeger for the taxable period beginning January 1, 1981, and ending on the date of his death, May 11, 1981. The court of appeals explained that both the deficiency notice and its attachments indicated that the deficiency related to the individual income tax Form 1040 filed on behalf of Yaeger personally, not to the fiduciary income tax Form 1041 filed by the estate for the period May 11, 1981, to April 30, 1982, which covered the estate's tax liability. *Id.* at 13a. It further noted that every adjustment in the attachments to the notice of deficiency related to items reported on Yaeger's Form 1040 for the period ending May 11, 1981 (*id.* at 13a-14a). In these circumstances, the court concluded, "[t]he notice of deficiency and its attachments clearly and fairly advised the estate that the commissioner intended to assess it for the short period reported in Yaeger's 1981 return" (*id.* at 14a).

ARGUMENT

The court of appeals correctly held that the interest expenses incurred by Yaeger in purchasing stocks and bonds for long-term capital appreciation constituted "investment interest" within the meaning of Section 163(d) of the Code and, therefore, were deductible only to the extent of his "investment income." The court also correctly rejected petitioners' contention that the notice of deficiency was invalid because it referred to the calendar year 1981, instead of the short taxable year caused by Yaeger's death. The court's decision is not in conflict with any decision of

this Court or of another court of appeals, and it presents no legal issue of broad importance that would warrant this Court's attention. Accordingly, there is no reason for further review.

1. Section 163(a) of the Code generally provides for the deduction of interest incurred on indebtedness. In the case of noncorporate taxpayers, however, Section 163(d) limits the deductibility of "investment interest" to the amount of the taxpayer's "investment income," plus $10,000—although disallowed amounts can be carried forward and deducted in future years (subject to the same limitation). The term "investment interest" is specifically defined by the statute as "interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment" (§ 163(d)(3)(D)).

Section 163(d), which originated in the Tax Reform Act of 1969, Pub. L. No. 91-172, § 221, 83 Stat. 487, was enacted to address the prevalent practice of borrowing money to purchase investment assets. Believing that allowing a current deduction for interest expenses designed to produce long-term investment gain produced a distortion of income, Congress acted to limit such interest deductions. The House Report noted that "[w]here the interest expense exceeds the taxpayer's investment income, it, in effect, is used to insulate other income from taxation," and that, even where "the receipt of the income from the investment may be postponed (and may be capital gains), the taxpayer will receive a current deduction for the interest expense even though it is substantially in excess of the income from the investment." H.R. Rep. No. 413, 91st Cong., 1st Sess. Pt. 1, at 72 (1969). Thus, Section 163(d) was designed to restrict the favorable tax consequences previously available to an individual who incurs interest ex-

penses in order to make long-term investments. See generally *Miller* v. *Commissioner*, 70 T.C. 448, 453-455 (1978).[8]

This case falls squarely within both the language and the purpose underlying Section 163(d). Since "investment interest" is specifically defined in the Code as interest on indebtedness incurred "to purchase or carry property held for investment" (§ 163 (d)(3)(D)), the court of appeals was clearly correct in holding that interest expenses incurred by an individual in purchasing stocks or bonds to earn money from long-term capital appreciation or dividends or interest—*i.e.*, for investment—constitute "investment interest" subject to the limitations on deductibility of Section 163(d), regardless of the amount of time that the individual devotes to his investment activities or whether he derives his livelihood exclusively from the earnings from his investments. Because it is undisputed that Yaeger's investment strategy was to purchase securities for the purpose of

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[8] As originally enacted in 1969, the term "investment income" included both long-term capital gain and short-term capital gain, as well as dividends and interest. In 1976, however, Congress eliminated long-term capital gain as an item of investment income against which investment interest could be offset, and it is this version of the statute that is applicable to the tax years at issue here, 1979 and 1980. See Tax Reform Act of 1976, Pub. L. No. 94-455, § 209, 90 Stat. 1542; I.R.C. § 163(d)(3)(B). Section 163(d) was revised substantially by Section 511 of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2244, effective for taxable years beginning after December 31, 1986. Under the 1986 Act, investment interest is deductible to the extent of net "investment income," which is now defined as the sum of (1) gross income from property held for investment and (2) any net gain attributable to the disposition of property held for investment. See 26 U.S.C. 163(d)(1) and (4)(B).

holding them for long-term capital appreciation, *i.e.*, for investment, the interest expenses that he incurred in financing these investments are subject to the limitations of Section 163(d). A contrary result would contravene not only the plain import of the statutory text, but also the congressional purpose of preventing a "mismatching of the investment income and related expenses of earning that income" (H.R. Rep. No. 413, *supra*, Pt. 1, at 72) by allowing Yaeger a current deduction for interest expenses incurred for the purpose of producing income in future years.

Petitioners argue (Pet. 11-18) that the interest expenses incurred by Yaeger in buying securities on margin are not "investment interest" within the meaning of Section 163(d), even though they were incurred to purchase assets for the purpose of holding them for long-term capital appreciation. Relying on a statement in H.R. Rep. No. 413, *supra*, Pt. 1, at 73 (see Pet. 16), petitioners maintain that any interest incurred in a trade or business is excluded from the reach of Section 163(d), and they further contend that Yaeger's stock market activities were so regular, continuous, and extensive that they qualified as the carrying on of a trade or business. This argument is without merit.

First, while the legislative history of Section 163(d) indicates that Congress anticipated that interest expenses incurred in carrying on a trade or business would be unaffected by that provision, it is clear from both the statute and the legislative history that Congress intended for investment interest to be governed by the statutory limitations. The statement relied upon by petitioners merely contrasts the type of interest not intended to be covered by the statute with interest "incurred * * * to purchase or carry

property held for investment" (H.R. Rep. No. 413, *supra*, Pt. 1, at 73); thus, there is no basis for suggesting that Congress intended to exclude interest incurred for the purpose of investing in the stock market from the reach of Section 163(d), even if the investment activity is so regular and extensive as to constitute the taxpayer's sole source of livelihood. Indeed, the distinction that petitioners seek to draw between smaller, part-time investors and larger, full-time investors is diametrically opposed to the thrust of Section 163(d). The concern that led to the enactment of Section 163(d) was that large investors were gaining an unwarranted tax advantage from the deduction of investment interest (see H.R. Rep. No. 413, *supra*, Pt. 1, at 72); in fact, the statute mitigates the effect on small investors by allowing the deduction of up to $10,000 in investment interest in excess of investment income. The exception for full-time investors that petitioners seek to create is at odds with both the plain language of Section 163(d) and its basic purpose.[9]

---

[9] Petitioners complain (Pet. 16) that the decision below unfairly precludes Yaeger from offsetting the interest expenses he incurred in purchasing securities on margin against the long-term capital gain he realized on the sale of those securities. This objection, however, has nothing to do with the issue in this case—*viz.*, whether Yaeger's interest expenses are excepted from the general rules governing investment interest because of the intensity of his investment activity; rather, it is a broad objection to the fairness of those general rules. Petitioners are complaining that Congress should not have excluded long-term capital gains from the definition of "investment income," which constitutes the limitation on the deductibility of investment interest. As we have noted (note 8, *supra*), prior to 1976 investment interest was deductible against long-term capital gain, as well as against short-term capital gain and dividends and interest, and there-

Moreover, the courts below correctly held that Yaeger's activity in investing in the stock market for his own account did not qualify as a "trade or business." This Court long ago established in *Higgins* v. *Commissioner*, 312 U.S. 212 (1941), that a taxpayer who merely manages his investments is not carrying on a trade or business, regardless of the extent or continuity of the transactions or the work required in managing the portfolio. See also *Moller* v. *United States*, 721 F.2d 810, 813-814 (Fed. Cir. 1983), cert. denied, 467 U.S. 1251 (1984); *Purvis* v. *Commissioner*, 530 F.2d 1332, 1334 (9th Cir. 1976). The courts have drawn a distinction between "investors" who purchase securities for long-term capital appreciation and income, and "traders" who buy and sell securities frequently in an attempt to profit from short-term price swings in the market. While the activities of "traders" have been recognized as a trade or business, the activities of investors, whether or not pursued on a full-time basis, have not been so regarded, in accordance with this Court's decision in *Higgins*. See, *e.g.*, *Moller* v. *United States*, *supra*; *Purvis* v. *Commissioner*, *supra*; *Liang* v. *Commissioner*, 23 T.C. 1040, 1043 (1955).

---

fore the situation of which petitioners complain did not exist prior to 1976. Congress then amended the statute, however, to eliminate long-term capital gain as an item of investment income against which investment interest could be deducted, creating *for all taxpayers* the alleged unfairness identified by petitioners. Thus, Congress specifically determined in 1976 that an individual should not be permitted to offset his investment interest against his long-term capital gain, and petitioners give no reason why it is particularly unfair to apply this determination to Yaeger's situation.

Applying this distinction to the situation of a particular taxpayer involves a factbound inquiry. Both courts below concluded here that Yaeger's activities were those of an investor, not a trader. He borrowed substantial sums to purchase securities for long-term capital appreciation, and his investment strategy was not designed to profit from short-swing changes in the market. The conclusion that this activity was that of an "investor" that does not rise to the level of a trade or business is fully consistent with the other cases that have applied this distinction.[10] Moreover, Yaeger's extensive borrowing for the purpose of financing long-term investments falls within the

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[10] There is clearly no merit to petitioners' contention (Pet. 11) that the decision below conflicts with the Fourth Circuit's decisions in *Commissioner* v. *Nubar*, 185 F.2d 584 (1950), cert. denied, 341 U.S. 925 (1951), and *Adda* v. *Commissioner*, 171 F.2d 457 (1948), cert. denied, 336 U.S. 952 (1949). Those cases did not involve the limitations on interest expense deductions contained in Section 163(d); rather, the question presented was whether a nonresident alien who engaged in frequent trades on United States commodities and stock markets was subject to United States taxation on his profits on the ground that he was engaged in a "trade or business" in the United States. The court of appeals did not address the general distinction between investors and traders and did not examine the market activity of the aliens in terms of whether the activity was primarily directed at short-term swings in the market or long-term appreciation. What the court of appeals did examine was the purpose of the statute involved there, concluding that Congress clearly intended that the type of activity involved in those cases would be subject to United States taxation. See *Commissioner* v. *Nubar*, 185 F.2d at 586. By contrast, petitioners' suggestion (Pet. 15) that an "investor" should be defined as one who intends to earn only "passive income from interest and dividends" is contrary to the existing case law. See, *e.g.*, *Moller* v. *Commissioner*, *supra*; *Purvis* v. *Commissioner*, *supra*.

situation that Congress was intending to address in enacting the limitations on deducting investment interest (see pages 10-11, *supra*), thus, there is no merit to petitioners' suggestion (Pet. 16-18) that the established "investor"/"trader" distinction applied by the courts below is at odds with the purpose of Section 163(d).

Petitioners are also mistaken in contending (Pet. 11-14) that the decision below conflicts with this Court's decision in *Commissioner* v. *Groetzinger*, 480 U.S. 23 (1987). The Court there held that a full-time gambler was engaged in a trade or business within the meaning of Section 162, notwithstanding that he made wagers solely for his own account and hence did not hold himself out to others as engaged in the selling of goods or services. Although the Court analogized the situation there to that of an active trader on the stock exchange (see 480 U.S. at 33-34), the Court did not reject the distinction drawn in lower court cases between investors and traders. Indeed, the Court noted that its decisions supported a distinction between traders and investors (*id.* at 31), and it cited without disapproval the cases on which the court below most heavily relied (*id.* at 34 n.13; see Pet. App. 7a-8a). In any event, the Court in *Groetzinger* plainly had no occasion to pass on the specific question presented here—whether interest expenses incurred by a full-time investor who purchases securities for long-term appreciation constitute "investment interest" subject to the limits on deductibility imposed by Section 163(d); thus, the disallowance of Yaeger's claimed interest deductions is fully consistent with this Court's decision.[11]

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[11] Even if petitioners were correct that *Groetzinger* should be viewed as casting doubt upon the line of cases denying

2. There is no merit to petitioners' contention that the notice of deficiency was invalid because it misstated the ending date of the taxable year. Yaeger reported his taxes on a calendar year basis, but because he died in the middle of 1981, his taxable year 1981 automatically ended on the date of his death (see I.R.C. § 443(a)). In the deficiency notice issued for 1981, however, the Commissioner erroneously identified the taxable period involved as the calendar year ending December 31, 1981, rather than the short period beginning January 1, 1981, and ending May 11, 1981, the date of Yaeger's death. The court of appeals correctly held that this technical error did not invalidate the notice of deficiency (Pet. App. 11a-14a).

The courts have long recognized that the purpose of a deficiency notice is to advise the taxpayer that the Commissioner has determined a deficiency in his tax for a particular tax period and that technical errors that do not thwart that basic purpose do not

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"trade or business" status to a full-time investor in the stock market who seeks to profit from long-term appreciation, the result in this case would be unaffected. Section 163(d) expressly imposes limitations on the deductibility of "investment interest," and that term is not defined in terms of "trade or business" activity. As we have noted, the remark in the legislative history suggesting that the statute does not cover interest expenses incurred in a trade or business was made to contrast such expenses with investment interest expenses; it plainly was premised on the existing understanding that an investor was not engaged in a trade or business. If, in the wake of *Groetzinger*, it can now be argued that an individual like Yaeger is engaged in the "trade or business" of investing, that might have ramifications under other provisions of the Code (see Pet. 18-19), but it would not permit such an individual to escape the limitations imposed by Section 163(d) on the deductibility of "investment interest."

invalidate the notice. See, *e.g.*, *Barnes* v. *Commissioner*, 408 F.2d 65, 68 (7th Cir.), cert. denied, 396 U.S. 836 (1969); *Commissioner* v. *Stewart*, 186 F.2d 239 (6th Cir. 1951); *Olsen* v. *Helvering*, 88 F.2d 650 (2d Cir. 1937). Moreover, the courts have specifically rejected petitioners' argument here that an incorrect reference to the taxable period involved necessarily invalidates a notice of deficiency. It is only where the taxpayer establishes that he was misled to his detriment by the error in the deficiency notice regarding the taxable year involved that the notice becomes invalid. See *Sanderling, Inc.* v. *Commissioner*, 571 F.2d 174 (3d Cir. 1978); *Estate of Scofield* v. *Commissioner*, 266 F.2d 154, 167 (6th Cir. 1959); *Commissioner* v. *Forest Glen Creamery Co.*, 98 F.2d 968, 971 (7th Cir. 1938), cert. denied, 306 U.S. 639 (1939); *Burford* v. *Commissioner*, 76 T.C. 96 (1981), aff'd, 786 F.2d 1151 (4th Cir. 1986).

Here, as the court of appeals explained (Pet. App. 13a-14a), the information provided to the estate in the deficiency notice itself and the attachments thereto clearly informed the estate that the notice pertained to the Form 1040 that the estate filed on Yaeger's behalf with respect to the taxable period ending May 11, 1981. Indeed, in moving in the Tax Court to have the deficiency notice declared invalid, petitioners never contended that they were misled or prejudiced by the error in that notice. Petitioners are attempting to seize upon a technical, harmless error in the deficiency notice to obtain a windfall at the expense of the public fisc. This error, however, did not invalidate the notice any more than would a typographical error in the taxpayer's name that did not cause any confusion. The court of appeals correctly rejected petitioners' claim.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

KENNETH W. STARR
Solicitor General

SHIRLEY D. PETERSON
Assistant Attorney General

RICHARD FARBER
MARY FRANCES CLARK
Attorneys

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No. 89-1233

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

ESTATE OF LOUIS YAEGER, DECEASED, JUDITH WINTERS, RAPHAEL MEISELS, ABRAHAM K. WEBER, AND THE BANK OF NEW YORK, EXECUTORS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY MEMORANDUM FOR THE PETITIONER

RICHARD A. LEVINE
ROBERTS & HOLLAND
Counsel of Record
30 Rockefeller Plaza
New York, New York 10112
(212) 903-8700

CARLTON M. SMITH
ROBERTS & HOLLAND
Counsel for Petitioner
30 Rockefeller Plaza
New York, New York 10112
(212) 903-8700

Of Counsel:
SIDNEY I. ROBERTS
ROBERTS & HOLLAND
30 Rockefeller Plaza
New York, New York 10112
(212) 903-8700

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ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY MEMORANDUM FOR THE PETITIONER

This reply to the Government's brief in opposition is filed for two reasons. First, the Government has raised an argument which was made by the Commissioner in the Tax Court, which the Tax Court rejected, and which was not asserted by the Government in the Second Circuit. This reply is also submitted to point out a relevant authority which was decided by this Court after the petition for certiorari in this case was filed.

In the Tax Court, the Commissioner argued that property constituting a capital asset whose sale would result in a long-term capital gain is, *per se*, investment property and that interest incurred to purchase or carry such property is, *per se*, investment interest, whether or not it is incurred in connection with a trade or business. This argument was rejected by the Tax Court below (Pet. App. 25a-26a) and has been repeatedly rejected by the Tax

Court. *See, e.g., Polakis v. Commissioner*, 91 T.C. 660 (1988); *King v. Commissioner*, 89 T.C. 445 (1987).

In effect, the Commissioner had argued before the Tax Court that it is the nature of the property, and not the nature of the activities of the taxpayer, which governs whether or not interest is investment interest subject to the limitation of section 163(d).[1] The Government appeared to abandon this argument when the case was before the Second Circuit Court of Appeals. In its brief to the Court of Appeals, the Government conceded that "Section 163(d) does not apply to interest paid to acquire property used in the taxpayer's trade or business . . .", citing as authority the fact that "the House Report states that 'interest on funds borrowed in connection with a trade or business would not be affected by the [section 163(d)] limitation'. H.R. Rep. No. 413, pt. 1 (1969), *supra* at 73." (Gov't. Brief to 2d Cir. at p. 18.)

In its opposing brief (Brief in Opp. at pp. 10-13), the Government appears to revert to the argument rejected by the Tax Court that it is the nature of the property, and not the nature of the activities of the taxpayer, which determines whether section 163(d) applies to the interest expense. In support of its argument, the Government characterizes the Congressional mandate that interest incurred in a trade or business is excluded from the reach of section 163(d) as merely indicating Congress' anticipation that interest incurred in carrying on a trade or business would not be affected by section 163(d). However, this position is directly contradicted by the following statement of the House Ways and Means Committee when section 163(d) was enacted:

> This limitation is to be applicable *only* to interest on indebtedness incurred or continued to purchase or carry property held for investment. Thus, interest incurred on funds borrowed for other purposes such as a home mortgage, installment purchases, consumer goods and personal or student loans would not be

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 (26 U.S.C.) (the "Code"), as amended and as in effect for the tax years 1979, 1980, and 1981.

> affected by the limitation. *In addition, interest on funds borrowed in connection with a trade or business would not be affected by the limitation. . . . Income or capital gains derived from the conduct of a trade or business are not to be considered investment income.* [H.R. Rep. No. 413, 91st Cong. 1st. Sess. pt. 1 (1969) at p. 73. (Emphasis added.)]

Section 163(d)(3)(B) specifically provides, as the quoted passage from the Committee Report states, that income and capital gains derived from the conduct of a trade or business are not investment income. This provision negates the Government's argument, since it would make no sense to exclude capital gains derived from a trade or business from the definition of investment income if, as the Government argues, the interest expense incurred with respect to such capital gain property used in a trade or business were considered investment interest. The fact that income and capital gains derived from the conduct of a trade or business are not investment income confirms that it is not the character of the gain, but the nature of the activities, which determines whether the interest expense is subject to the section 163(d) limitation.[2] The exception for interest expense incurred in a trade or business is provided because there is no logical reason to treat interest expense incurred in a trade or business differently from other expenses incurred in a trade or business.

The change made to section 163(d) by the Tax Reform Act of 1976 to eliminate the deduction of investment interest against long-term capital gain from the sale of investment assets (Pub. L. No. 94-455, §209(a)(1)) has no bearing whatsoever on the issue of how a person who is engaged in a trade or business should be treated, nor does it affect the determination as to whether a person is an investor or is engaged in a trade or

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[2] If Congress had meant to limit the deduction for interest expense incurred to purchase or carry capital assets, it could have used that term in the statutory definition of "investment interest" or it could have so stated in the legislative history. *Compare* section 165(c)(1), (2) and (3) *with* section 165(f) and (g). *Cf.* section 170(b)(1)(C). This Congress did not do.

business. The Committee Report accompanying this change makes it clear that the exclusion from section 163(d) of interest incurred in a trade or business was not affected by the 1976 change. H.R. Rep. No. 658, 94th Cong., 1st. Sess. (1975) at pp. 103 n. 1 and 104.[3]

In its brief, the Government attempts to represent petitioner's position as contending that a full-time investor in the stock market is in a trade or business. (Brief in Opp. at p. 13.) Yet, as the Government knows full well (and as clearly set forth in the Petition at p. 12), petitioner agrees that an investor in the stock market is not engaged in a trade or business, regardless how extensive his activities. The question presented in this case, however, is whether the full-time speculative buying and selling activities of Louis Yaeger were so extensive that they constituted a trade or business and not those of an investor. By restating petitioner's position, the Government seeks to avoid dealing with the question of the validity of the judicially created requirement adopted by the courts below that one must profit from short-term swings in the market in order to be in a trade or business.

The Government erroneously denies that the decision of the Second Circuit below conflicts with the Fourth Circuit's decisions in *Commissioner v. Nubar*, 185 F.2d 584 (1950), *cert. denied* 341 U.S. 925 (1951), and *Adda v. Commissioner*, 171 F.2d 457 (1948), *cert. denied* 336 U.S. 952 (1949), on the grounds that those cases did not involve the limitation on the deduction of interest expense contained in section 163(d) but concerned whether a non-resident alien who was actively engaged in buying and selling securities was engaged in a trade or business in the United States. (Brief in Opp. at p. 15, n. 10.)

The Government's assertion that *Nubar* and *Adda* should, in effect, be ignored by this Court is quite startling. Since none

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[3] As originally proposed, the House Amendment to section 163(d) in 1976 expanded the interest limitation to all "non-business" interest (*i.e.*, personal and investment interest). This further indicates a Congressional intention not to place any limitation on interest expense incurred in a trade or business. H.R. Rep. 658, *supra*, at 103-105.

of the cases upon which the Government relies involves the precise issue of "trade or business" under section 163(d), the fact that neither *Nubar* nor *Adda* deals with that precise issue can hardly be deemed proper grounds for ignoring them.

Moreover, the source of all of the confusion in the law – and the case on which the Government and the courts below rely – *Liang v. Commissioner*, 23 T.C. 1040 (1955), involved the identical issue as in *Nubar* and *Adda* – *viz.*, whether a nonresident alien was engaged in a trade or business in the United States within the meaning of section 211(b) of the 1939 Code.

In sum, the Commissioner cannot explain away the results of the Court of Appeals cases decided after the Supreme Court's decision in *Higgins v. Commissioner*, 312 U.S. 212 (1941), *i.e.*, *Fuld v. Commissioner*, 139 F.2d 465 (2d Cir. 1943), *Levin v. United States*, 597 F.2d 760 (Ct. Cl. 1979), *Nubar* and *Adda*, which, on substantially similar facts, support the Estate's position that seeking to profit from short-term swings is a factor to consider, but is not a requirement which must be met in order to be engaged in a trade or business. On the other hand, the cases which the Government cites involved facts which would not demonstrate trade or business status even without consideration of a short-term holding factor. The courts in those cases were not required to and did not focus on the issue of whether lack of short-term holding alone would be sufficient to deny trade or business status where all the other facts indicate trade or business status. Even *Moller v. United States*, 721 F.2d 810 (Fed. Cir. 1983), *cert. denied*, 467 U.S. 1251 (1984); and *Purvis v. Commissioner*, 530 F.2d 1332 (9th Cir. 1976), upon which the Government relies, support the Estate's position in this regard.

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The second question presented by petitioner relates to the jurisdiction of the United States Tax Court to determine a deficiency in income tax with respect to the tax year ended May 11, 1981, even though that year is nowhere mentioned either in the notice of deficiency issued by the Commissioner, the petition

filed with the Tax Court by the taxpayer or the answer to the petition filed by the Commissioner. Pursuant to Rule 22.6 petitioner wishes to call to the Court's attention this Court's recent decision in *United States v. Dalm*, ____ U.S. ____, 110 S. Ct. 1361 (March 20, 1990), which was rendered after petitioner filed its petition for writ of certiorari.

In *United States v. Dalm*, this Court emphasized the paramount importance in tax cases of strict compliance with the statutory provisions which confer jurisdiction. In reversing the Sixth Circuit Court of Appeals, the Court held that the district court could obtain jurisdiction only if the specific statutory requirements were met, notwithstanding the compelling equities involved in that case to expand the district court's jurisdiction. In the instant case, the United States admits in its brief in opposition (Brief in Opp. at pp. 8-9, 17) that the notice of deficiency issued by the Commissioner sets forth an incorrect taxable year and that it fails to set forth the taxable year which the Commissioner says he wishes to litigate in the Tax Court. Simply put, the Commissioner has failed to comply with the provisions of the Internal Revenue Code which limit the jurisdiction of the Tax Court to determine tax liability to the year or years set forth in the notice of deficiency. (See sections 6212, 6213 and 6214.)

In *United States v. Dalm*, this Court determined that jurisdiction must be conferred by statute and is not gained by relying on equitable principles. In the instant case, the Tax Court correctly held that it does not have jurisdiction to determine a deficiency with respect to a taxable year which is nowhere set forth in the notice of deficiency, or in the pleadings. The Commissioner seeks to avoid the effects of his erroneous notice of deficiency and of the fact that the statute of limitations for issuing a correct notice of deficiency has expired, by simply having the court order, by fiat, that the Tax Court has jurisdiction over a different taxable year. This Court should reverse the decision of the Second Circuit Court of Appeals which granted (indeed imposed) jurisdiction on the Tax Court for a taxable year not set forth in the notice of deficiency.

CONCLUSION

For these reasons and for those set forth in the petition, it is respectfully submitted that the petition for a writ of certiorari should be granted.

Respectfully submitted,

RICHARD A. LEVINE*
CARLTON M. SMITH
SIDNEY I. ROBERTS**
ROBERTS & HOLLAND
30 Rockefeller Plaza
New York, NY 10112
(212) 903-8700

Counsel for Petitioner

*Counsel of Record
**Of Counsel

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